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SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS—PART II

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

CONSIDERING PROPOSED CHANGES TO THE SECURITIES LAWS THAT ARE INTENDED TO STIMULATE INITIAL PUBLIC OFFERINGS ("IPO") OF SECURITIES AND HELP STARTUPS AND EXISTING BUSINESSES TO RAISE CAPITAL WHILE PROMOTING JOB GROWTH AND PROTECTING INVESTORS

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C O N T E N T S

TUESDAY, MARCH 6, 2012

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS—PART II

TUESDAY, MARCH 6, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed, presiding.

OPENING STATEMENT OF SENATOR JACK REED

Senator REED. Good morning. I call the hearing to order the hearing this morning, entitled "Spurring Job Growth through Capital Formation while Protecting Investors, Part II." Unfortunately, Chairman Johnson had a prior commitment with the Energy Committee today and will not be able to attend. I understand also that Senator Shelby will not be able to attend. So Senator Crapo and I will do our best. We want to thank you all for the valuable time and valuable insights that you will provide us this morning.

Senator Johnson also asked that I submit his statement for the record, and without objection, his statement and all the statements will be submitted for the record.

Senator REED. When I conclude my remarks, I will recognize Senator Crapo, then ask my colleagues if they have any opening remarks also.

This is the fourth in a series of hearings by the Banking Committee on capital formation issues, including one held by Senator Tester in the Subcommittee on Economic Policy and one held by the Subcommittee that I chair on Securities, Insurance, and Investment.

Job creation and revitalizing the growth of American businesses are two of the top issues facing our country right now. These are the issues that Americans are rightfully urging us to find ways to address. Entrepreneurial businesses need access to capital to fund the search for new ideas, the development of new products, and ultimately the hiring of new workers. At the same time, as we know from our country's own history, investors are more willing to invest when they are appropriately protected, so raising capital and assuring investors go hand in hand.

This morning, we will focus on some of the legislative proposals introduced in this area, including creating an on-ramp for emerging-growth companies, Regulation A and its offering limit, Regulation D and its requirements on solicitation, the 500 shareholders

of record threshold for private banks and other companies to become public, and the issue of crowdfunding.

The first Federal securities laws followed in the wake of the stock market crash of 1929, and the Securities Act of 1933, enacted as the "Truth in Securities Act," required disclosures. As President Roosevelt stated at the time, "This proposal adds to the ancient rule of 'caveat emptor,' the further doctrine 'let the seller also beware.'" It puts the burden for telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

With the fragile economic recovery and continued high unemployment, directing the flow of capital to enterprises that would improve the economy is vital to putting people back to work. However, we must not forget that gaps in regulation and lack of transparency were contributing factors to the enormous losses suffered as a result of the financial crisis.

As we consider these capital formation bills, we must be mindful to not re-create the very problems that we just tried to solve when we enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. Indeed, even with these steps, as we go forward, unfortunately, we are seeing incidents of market irregularities, from insider trading to micro stock capital fraud schemes. There remains the potential for investors to be harmed, and we have to recognize that potential.

Today's hearing will continue the Banking Committee's examination of different proposals to update and streamline our capital-raising process. This process requires finding the right balance between ensuring entrepreneurial businesses have access to capital to fund new products and provide jobs while providing accurate information to investors so they have the opportunity to make sound investment choices. And I look forward to our witnesses' and to my colleagues' presentations.

With that, let me recognize Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I appreciate the fact that we are holding this hearing, and I look forward to the information that our witnesses will provide to us, and I welcome the witnesses.

As the December 1st and 14th hearings highlighted, we can do more to expand economic activity by removing unnecessary restrictions on capital formation to enhance access to capital for early stage startups as well as later-stage growth companies. Later this week, the House of Representatives is expected to pass a package of reforms that include increasing the 500-shareholder registration threshold, expanding the scope of Regulation A offerings to $50 million, permitting general solicitation of investors in Regulation D offerings, allowing small businesses and startups to raise capital from small-dollar investors through crowdfunding, and, finally, providing an on-ramp that would provide emerging-growth companies up to 5 years to scale up to IPO regulation and disclosure compliance.

In the Securities Subcommittee hearing in December, Kate Mitchell of Scale Venture Partners talked about the fact that dur-

ing the past 15 years, the number of emerging-growth companies entering capital markets through IPOs has plummeted relative to historical norms. From 1990 to 1996, 1,272 U.S. venture-backed companies went public on U.S. exchanges, yet from 2004 to 2010, there were just 324 of those offerings. This decline is troubling as more than 90 percent of company job growth occurs after an IPO.

The IPO Task Force recommended providing an on-ramp that would provide emerging-growth companies up to 5 years to scale up to regulation and disclosure compliance. During this period emerging-growth companies could follow streamlined financial statement requirements and minimize compliance costs and be exempted from certain regulatory requirements imposed by Sarbanes-Oxley and Dodd-Frank.

On December 8th, SBA Administrator Karen Mills and National Economic Council Director Gene Sperling posted a joint online statement about helping job creators get the capital they need by passing legislation relating to crowdfunding, Regulation A mini-offerings, and creating an on-ramp for emerging-growth companies. There is strong bipartisan support for these proposals, and I look forward to working together with my colleagues and others to enact necessary changes to promote investment and American job growth while protecting the investors.

Again, Mr. Chairman, I appreciate the fact that we are holding this hearing. I look forward to the input that our witnesses will provide to us today.

Senator REED. Thank you very much, Senator Crapo.

Following the early bird rule, let me ask if Senator Tester has an opening statement or any comments. No? Then, Senator Schumer, the next Democrat.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. I do. Thank you, Mr. Chairman. And I thank you for holding this hearing. It is the fourth time in recent months—and I thank Chairman Johnson as well, as well as Senator Shelby. It is the fourth time in recent months that this Committee or one of our Subcommittees has considered the issue of capital formation and the legislative proposals being discussed here today.

This week, the House Republican leadership is scheduled to vote on a package of bills encouraging capital formation for growing companies. If the House package looks familiar, it is because it includes several proposals already advancing in the Senate. Speaking on behalf of some of us here in the Senate, we are glad to see the House endorsing a few of our ideas.

The House package, for instance, borrows from a bill proposed by Senator Toomey and myself that would provide a transition period for emerging-growth companies to make it easier for these companies to go public. The House package also includes a measure to raise the offering limit under Regulation A from $5 million to $50 million, a proposal championed in the Senate by Senator Tester and supported by Senators Toomey and Menendez.

In addition, Senators Warner and Toomey have joined Senator Carper on a bill that recognizes the reality that companies are taking longer to go public and would, therefore, help fast-growing com-

panies use stock to pay their employees without undergoing a cumbersome SEC registration process ordinarily designed for companies issuing stock to the general public. The proposal also made it into the House package being voted on this week. So the House package took a lot of bipartisan Senate proposals that had bipartisan support in the House and put it together, which is good.

There is no reason why the Senate should not bundle these same proposals together, just like the House has, and we will. Leader Reid has already indicated the Senate will assemble a bipartisan package. The Senate version will probably go a little further than the House version, and I would hope that we would also take up some needed precautions on investor protection, which Senator Jack Reed and others have reminded us is important.

Given the level of bipartisan support for many of these proposals, passage in the Senate appears not to be a question of if but of when. I expect a comprehensive Senate proposal could be announced in the coming days, and this is an important area for the Senate to address. Many recent IPOs and proposed IPOs—Zynga, Groupon, Facebook—have generated a lot of hype, but the actual numbers, if you are a small startup, not one of the ones that gets a lot of focus and glamour, that tells a different story. There have been ups and downs over the years, but the number of U.S. IPOs has actually drastically declined since the mid-1990s, and companies are taking almost twice as long to go public than they were then.

I agree with some of today's witnesses who argue that there is not one simple reason for decline in U.S. IPOs, but I do think Congress has an ongoing obligation to ask whether the policy framework for public offerings is striking the right balance between facilitating capital formation on the one hand and attempting to protect investors on the other. That is always a needle we have to thread.

If you ask the people running emerging-growth companies and looking to raise capital to build their businesses, they will tell you why our bill is important. In a recent survey, 79 percent of those CEOs said the U.S. IPO market is not accessible for small companies, and 85 percent said going public is not as attractive today as it was in 1995. The primary reasons cited were regulatory and compliance burdens. This matters because a threat to the U.S. IPO market represents a direct threat to U.S. job creation. Historically, over 90 percent of job creation at U.S. public companies has occurred post-IPO. And according to testimony we will hear from Mr. Rowe, "Data show that companies that go public grow their headcount approximately 5-fold."

It is also important to point out that our IPO on-ramp is designed to be temporary, transitional, and limited. At any given time, only 11 to 15 percent of companies will qualify as emerging-growth companies, and those companies will only account for about 3 percent of market capitalization. Big-name companies who have gone public recently would not have qualified as emerging-growth companies. Neither Groupon nor Zynga would have qualified, and, of course, Facebook is not even in the ballpark.

Finally, I should note that the IPO on-ramp we are proposing is not mandatory. If investors feel they require more protection, they

would be free to request it from the issuer. Indeed, Carlyle recently filed to go public, and its registration statement included a provision that would have prevented investors from suing in court for securities fraud claims. Investors objected; Carlyle and its advisers amended the terms of the offering to remove the provision.

In conclusion, Mr. Chairman, all of the bills we are considering today would advance the goal of capital formation and job creation. They all have bipartisan support from Members of this Committee. I see Michael Bennet has walked in, and he has another proposal that we are working on as well. Many have passed the House with over 400 votes, and I am glad to see our Committee devoting so much time to the issue of capital formation.

I look forward to working with Chairman Johnson, Ranking Member Shelby, and the rest of my colleagues to see that the Senate passes a significant package of legislative proposals to help small companies raise capital and grow their businesses, and I am confident we will be successful.

Thank you for the time, Mr. Chairman.

Senator REED. Senator Corker?

Senator CORKER. As is my custom, I think we benefit so much more listening to our witnesses than listening to us, so I look forward to that.

Senator REED. Senator Moran, do you have a comment?

Senator MORAN. While I agree with the Senator from Tennessee, I do have an opening statement.

[Laughter.]

Senator SCHUMER. He was not directing it at you, Mr. Moran.

STATEMENT OF SENATOR JERRY MORAN

Senator MORAN. It did not seem like a very good segue.

Mr. Chairman, thank you. It is a privilege to be here and to hear our witnesses, and I look forward to that moment. I just wanted to highlight legislation that I and Senator Warner, also a Member of this Committee, have introduced, which is called the Startup Act, and a significant component of the Startup Act is capital formation provisions. It also includes items related to regulatory balance, to employment of entrepreneurial and highly skilled talent, and promotion of commercialization for research done using Federal dollars.

We are also working to bring in others with the ideas that Senator Schumer and others have mentioned in their opening remarks, provisions of Senator Tester's legislation, provisions that Senator Bennet supports, Senator Toomey, and Senator Crapo.

We discovered in reviewing the research done by the Kauffman Foundation in Kansas City that startup companies that are less than 5-years old accounted for nearly all net jobs created in the United States from 1980 to 2005. And as we look at trying to balance our budget, grow our economy, and put people to work, the ability to create an environment in this country that is entrepreneurial is so critical. And so we look forward to working with the Majority Leader and others as they craft legislation that is designed to create opportunities for greater entrepreneurial efforts in the United States and try to create the opportunity for success.

So we welcome the opportunity to work with the Senators I mentioned as well as those who are interested in this topic, and I appreciate the opportunity to be here to hear these witnesses that Senator Corker so appropriately indicated were more articulate and more highly educated and informing than the Senator from Kansas.

Senator REED. We thank the Senator from Kansas.

Senator Bennet, do you have a comment?

STATEMENT OF SENATOR MICHAEL F. BENNET

Senator BENNET. I am nowhere near as bold as the Senator from Kansas, so I am going to avoid the derision of the Senator from Tennessee and not make an opening statement. I do want to recognize Lynn Turner, who is here from the great State of Colorado—thank you very much for testifying—and simply say, Mr. Chairman, how important this discussion is for our economic future.

A lot of people do not know that our gross domestic product is actually higher today than it was before we went into this recession. The reason they do not know that is because we have become so productive as an economy that we are producing that economic output with a lot fewer people, and we are seeing median family income continue to decline in this country. That is a huge problem. And the only way it is going to be resolved, I think, is through the kind of initiatives that the Senator from Kansas has talked about and by educating our people. Those are the two things that we need to do in order to drive an economy that is actually creating jobs and lifting income in the United States.

So I look forward to hearing the witnesses.

Senator REED. Thank you very much.

Senator REED. Let me now introduce the panel.

Our first witness is Mr. William Waddill. He is the Senior Vice President and Chief Financial Officer of OncoMed Pharmaceuticals, Incorporated. It is a privately held company based in Redwood City, California. He has decades of experience in life science and public accounting and has helped startups grow. Thank you very much, sir.

Our next witness is Professor Jay Ritter. Professor Ritter is the Cordell Professor of Finance at the University of Florida. Over the past 25 years, Professor Ritter has authored many articles and books on IPOs and is one of the most cited authorities on this subject. Thank you, sir.

Our next witness is Ms. Kathleen Shelton Smith. She is the founder and principal of Renaissance Capital. Founded in 1991, her firm, which is headquartered in Greenwich, Connecticut, is a leader in providing institutional research and investment management services for newly public companies, and she has done a tremendous amount of data gathering and analysis related to IPOs, and we look forward to your testimony. Thank you.

Our next witness is Mr. Tim Rowe. Mr. Rowe is the founder and Chief Executive Officer of Cambridge Innovation Center located in Cambridge, Massachusetts. Previously, he has served as a lecturer at the MIT Sloan School of Management, as a manager with the Boston Consulting Group, and has over a decade-long experience

with startups and early stage venture capital. Thank you, Mr. Rowe.

Our final witness is Mr. Lynn Turner, who is no stranger to this Committee. He is a former Chief Accountant of the Securities and Exchange Commission and is currently a Managing Director of LitiNomics, which has offices in Mountain View, Oakland, and Los Angeles, California. His expertise in issues related to accounting and investor protection has been helpful to the Committee in the past, and I look forward to his testimony. Thank you.

I want to welcome all of you again. Thank you for your willingness and your insights today. Mr. Waddill, you may proceed with your testimony.

STATEMENT OF WILLIAM D. WADDILL, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, ONCOMED PHARMACEUTICALS, INC., ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. WADDILL. Thank you and good morning, Mr. Chairman, Members of the Committee, ladies and gentlemen. My name is Will Waddill. I am Senior Vice President of OncoMed Pharmaceuticals out in Redwood City, California. I want to thank you for the opportunity to speak with you today about unique hurdles of innovation companies like OncoMed that are facing and the opportunity that the Congress faces to try and get us past those hurdles.

It takes decades and more than $1 billion to bring therapies to market in my sector of the world. In order to finance research and development, we must cultivate a wide range of public and private investors. Startup companies depend on venture capital in the early stages and later look to public markets to pay for the more expensive clinical trials as we develop our compounds.

However, due to the current economic climate and economic realities that are hitting the venture capital community, public markets are both slow to recover, as has been noted this morning, which creates a barrier for us to progress our therapies.

The issue facing all of us across the board in the innovation sector really is the ability to access that capital, so I strongly support Senator Schumer and Senator Toomey in the effort to create an on-ramping for public market for emerging companies like mine.

One of the key components of the on-ramp is the 5-year transition period to comply with Sarbanes-Oxley Section 404. That could have an immediate impact on capital that I will be able to divert more toward developing a product instead of paying for administrative costs in the company.

Currently, these opportunity costs of compliance can be quite damaging and cause delays while I go out as a chief financial officer with other members of our management team to raise capital.

Newly public companies have virtually no product revenue, so all operating capital must come from investors. Now, this is a key point to understand that when you are in an innovation stage, you are shooting for products, you are developing products, and you want to have all your capital go toward those products versus building infrastructure to comply with the regulations.

Because of this facing my company, which is a private company, we do fit into that 86 percent that looks at this and says, hey, you

know, this is a cost burden for us and will cause us significant costs in the first few years of being a public company.

So for companies that are still too small for the public markets, another portion of this legislation is Regulation A. And the current regulation, which was set in 1992, $5 million, the proposal is to raise that to $50 million, and this, again, will open up barriers in front of us to raise more capital. I support Senators Tester and Toomey's legislation to increase this to $50 million. This higher limit would raise Regulation A to match the realities of the current marketplace.

Specific to my industry, it costs anywhere from $800 million to $1.2 billion to get a product through clinical trials and onto the marketplace. It is an enormous sum of money, and it is an investment time that I talked about earlier, while you are in the innovation stage, that is critical that you have your focus on not only your people but also your capital in developing those products.

Our hope would be to do that and get to the point where we could be a Genentech, where we could be a Gilead out in the world. And when you look across the bay in various sectors where we live, we would want to be a Hewlett-Packard. We want to have job creation that gets up to a 10,000-, 20,000-, 30,000-person company. But we cannot do that unless we have early stage capital. So by creating this IPO on-ramp, reforming Regulation A, that is an opportunity for us to do exactly that.

So with that, I would like to thank the Members for being here, and I am happy to answer questions when we get to them. Thank you.

Senator BENNET. [Presiding.] Thank you for your testimony.

Professor Ritter.

STATEMENT OF JAY R. RITTER, CORDELL PROFESSOR OF FINANCE, WARRINGTON COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF FLORIDA

Mr. RITTER. Thank you. My name is Jay Ritter. I am a Professor of Finance at the University of Florida, and I have studied initial public offerings for more than 30 years.

I will first give some general remarks on the reasons for the low level of IPO activity this decade and the implications for job creation and economic growth and then a few suggestions on specific bills that the Senate is considering.

First of all, there is no disagreement about the huge drop, prolonged drop in small-company IPOs that we have seen for 11 years now. But there is disagreement about the reason for the prolonged decline, the implications for the economy, and what should be done, if anything, to rejuvenate the IPO market and spur capital formation.

The conventional wisdom is that a combination of factors, including heavy-handed regulation such as Sarbanes-Oxley and a drop in analyst coverage of small companies, have discouraged companies, especially small companies, from going public. I agree with this conventional wisdom in terms of being causes of the decline in IPOs, but I think that this is only a minor cause for the huge and prolonged decline. I think the more general problem is the lack of profitability of small companies, and this is not so much a private

versus public company issue as a big company versus small company issue.

I think that there has been a long-term worldwide trend favoring big companies that can realize economies of scale, economies of scope, bring products to market more quickly. And this is one of the reasons for the increased right-skewness in the income distribution in the world, income distribution and wealth distribution, and I think the IPO market in the United States is just a microcosm, one of the trees in the big forest. And if this is the fundamental reason why very few small companies are going public, because small is not the optimal way of organizing a lot of businesses, but instead getting big fast has become more important than it used to be, then I think a lot of these proposed changes are going to have minimal effects on spurring small-company investing and rejuvenating the IPO market.

Now, consistent with this idea that the problem is being small in many industries is a lot less advantageous than it used to be, there is a whole body of facts consistent with this. For one thing, small companies that are publicly traded have had a long-term down trend in their profitability. Indeed, of the small companies that have gone public since 2000, over the last 11 years, only 27 percent of them have had positive profits in one of the 3 years after going public.

Investors have earned very low returns, way below investing in bigger companies, in the last decade, and that was true in the 1990s and the 1980s as well. And it is true not only in the United States, but it is true in Europe, that if you look at European markets for small companies, the returns that investors have earned have been far below the returns on bigger-company IPOs and more established companies.

So investors have gotten burned way too many times on investing in small companies, and it is the lack of small companies that become successful big companies that is largely responsible for the lack of investor enthusiasm. They do not want to get burned time and time again.

Now, that is not to say that Sarbanes-Oxley costs and other things have not had some effect on the profitability of small companies, but in work that I have done with co-authors, we have computed how many of them would have been profitable if they did not have the extra compliance costs. And we find that there would be some effect, but still that long-term down trend in profitability would still be there.

Now, in terms of the implications for job growth, there have been a lot of numbers put out by Kate Mitchell before this Committee that have been repeated in the Wall Street Journal. One number that has been out there is 22 million jobs would have been created if IPO activity had just continued to be what it used to be. I have actually been doing some work currently for the Kauffman Foundation looking at the actual job growth of all the companies that have gone public since 1996, and the numbers we are coming up with are dramatically lower. Companies that have gone public in the late 1990s that have had 10 years of experience on average increased their post-IPO employment by 60 percent, a compound growth rate of 4.8 percent per year.

Now, the numbers are higher for venture-backed companies than, for instance, for older, more mature companies that have gone public. But I do not think increasing the number of IPOs is automatically going to spur an enormous amount of job growth. That said, I would like to see a healthy IPO market where good companies can get financing at terms that reflect their prospects and create wealth for society, investors, and spur employment.

Senator BENNET. Thank you, Professor.

Ms. Smith.

STATEMENT OF KATHLEEN SHELTON SMITH, CO-FOUNDER AND CHAIRMAN, RENAISSANCE CAPITAL, LLC

Ms. SMITH. Thank you. Members of the Committee, thank you for inviting me to testify today. Capital formation, when accomplished through the IPO market, plays an important role in funding our best entrepreneurial companies. So it is no surprise that in looking to spur job growth, all eyes would turn to the IPO market—America's most admired system for funding entrepreneurs.

We share the concerns of lawmakers about the IPO market and are honored to be asked for our thoughts. For over 20 years, Renaissance Capital has had a singular focus on the IPO market. We are involved in IPOs in three ways: we are an independent research firm providing institutional investors with analysis of IPOs; we are an indexing firm creating IPO indices that measure the investment returns of newly public companies; and we are an investor in newly public companies through a mutual fund and separately managed institutional accounts.

I will start by examining the condition of the U.S. IPO market, including where we stand globally and the importance of investor returns in the equation. I will then make suggestions on the specific bills under consideration.

IPO markets around the world were hurt by the 2008 U.S. financial crisis and the 2011 European sovereign debt crisis. And yet the United States accounted for 32 percent of global IPO proceeds during each of those years, larger than any other IPO market in the world. So despite what appears to be low IPO issuance levels in recent years, much of the U.S. IPO market is functioning quite well under challenging conditions.

The IPO Task Force provided helpful data about large and small IPO issuance since 1991. This data, which is contained in my written testimony, shows that while smaller IPOs have disappeared, larger companies raising over $50 million in IPO proceeds continue to access the IPO market. We find little evidence that these larger issuers are deterred from wanting to tap the IPO market. Today we count over 200 companies in our U.S. IPO pipeline, 92 percent with deal sizes over $50 million. They are seeking to raise over $52 billion in total, the biggest we have seen in a decade. All these companies have undergone financial audits, implemented Sarbanes-Oxley policies, and filed full disclosure documents with the SEC.

On the other hand, as the IPO Task Force concluded, smaller, sub-$50 million IPOs have practically disappeared from the market. Now, we can ease the path for IPO issuance for these smaller companies, but it only works if real investors are interested in buy-

ing these IPOs. At present, the trading market for IPOs is highly volatile with share turnover on the first day of trading at times exceeding the number of shares offered. This suggests that IPO shares are being placed with short-term trading clients of the IPO Underwriters. We urge policymakers to study ways to encourage IPO Underwriters to allocate IPOs to a broader base of long-term investors.

But the most powerful way to fix the IPO market is to improve returns for IPO investors. There is a chart in my written testimony that shows how positive returns drive IPO issuance, and how poor returns shut down the market entirely. Unfortunately, there is very little policymakers can do about this.

The bursting of the Internet bubble over 10 years ago devastated IPO investors, far worse than the rest of the equity markets overall. Over 70 percent of those IPOs during that period were unprofitable companies whose offerings were promoted by the IPO Underwriters' research analysts. No wonder in the years following that disaster investors have avoided small IPOs.

Our suggestions on the proposed bills include the following:

First, properly define "emerging-growth company" to target the really smaller issuers seeking to raise up to $50 million who have disappeared from the IPO market.

Second, strike the proposed informational rules in the bills that permit Underwriters' research analysts to promote offerings and obtain access to special information during the IPO process.

And, third, the proposed private company bills should assist the smaller companies and add a market capitalization limit to prevent larger IPO-ready companies from enjoying an active trading market in their shares while avoiding public disclosure.

To summarize, a well-functioning IPO market is based on the principle of full, transparent, and honest disclosure of company information available evenly to all public investors. The U.S. IPO market has been functioning well under the stressful conditions of a global financial crisis. While policy initiatives may help the most vulnerable, sub-$50 million issuers to enter the market, it is positive returns that will lead the way to a rising appetite by IPO investors for smaller IPOs. Waiving certain disclosure and stock promotion rules that result in misallocating capital to weak or fraudulent companies will only endanger the recovery of the IPO market.

Thank you for inviting me to appear before you today.

Senator BENNET. Thank you very much for your testimony.

Mr. Rowe.

STATEMENT OF TIMOTHY ROWE, FOUNDER AND CEO, CAMBRIDGE INNOVATION CENTER

Mr. ROWE. Thank you very much, Chairman.

Senator BENNET. I like the sound of that.

[Laughter.]

Senator BENNET. It is fleeting, though.

Mr. ROWE. Isn't everything?

I want to thank Senator Bennet and Senator Merkley and Senator Brown, who is not on this Committee, for bringing forward crowdfunding proposals. I want to talk about that today. I think they are very exciting.

First let me just briefly introduce myself. I am Tim Rowe. I run Cambridge Innovation Center. Cambridge Innovation Center is a facility in Kendall Square that sits next to MIT. We have about 450 startups going in this one office tower. We are told that we have more startups in one building at CIC than anywhere else in the world. And it is my background, having worked with these guys and, you know, about 1,000 startups overall over our history, that I bring to this discussion.

What is exciting to me about the moment we are in is that we have the potential to really radically change the system by which we create new companies in this country. As Senator Moran raised when he quoted Kauffman Foundation data, we think now that most new jobs are coming from startups, companies 5-years old and younger. I was told I could not really show slides here, but I am going to cheat and turn my laptop around.

[Laughter.]

Mr. ROWE. This is the Kauffman Foundation chart that I think you are all familiar with. You have probably seen it in other people's presentations. The blue is the jobs created by startups. The black is the jobs lost by existing companies, all companies 6-years old and older. This data has been pretty broadly vetted. Oh, it went dark. Did you see it before? All right. So it has been pretty broadly vetted, and what it says is that we need more startups.

Now, we have got 80 percent of the world's venture capital in this country. We are awesome at this stuff. We are really good at innovation. This is where we are leading. Unfortunately, that venture capital only is good for the small percentage of companies that are very high growth companies, perhaps will be worth $1 billion. Most of the new companies in this country, as we all know, are local businesses. It may be a restaurant, somebody starting a construction company, somebody launching a plumbing business. These businesses are not going to be financed by venture capitalists, and for the large part, they are not going to be financed by angel investors. And, generally speaking, we have resorted to Government support through SBA loans and other programs like that.

What we have in front of us is the possibility, through Senator Merkley's bill, through your bill, together with you, Senator Bennet, and Senator Brown's bill, to really change this and make it legal for people to help each other, for neighbors to help neighbors, people on your PTA committee, people in your Facebook friends circle, to help you start your business. This is a really healthy thing. We have seen this kind of thing happen in other countries. People talk about microfinance and so forth. It is just really exciting.

I do not think there is really any disagreement that it is exciting. I think the disagreement or the concern—and it is well placed—is: Is there going to be fraud? Are bad people going to take advantage of good legislation to somehow, you know, screw us over? We have got to make sure that does not happen.

So I have been on the phone with people from all over the country and around the world trying to learn about this. I am not a legislative guy. I am not an expert in this stuff. But I have been asking a lot of questions and pulling together data.

It turns out there is a crowdfunding investing company that exists already. It is up and running; it is working. And the only rea-

son it is legal is it is in the U.K. where they already have laws that permit this. And so they have a lot of data. They have only been up and running for about a year, but the data show, interestingly, that they have had zero claims of fraud so far through this system. What they are doing is very similar to what eBay does. When you go on there and you list something, they have systems to make sure that what is listed is true. They do background checks. They do make sure that the basic offering is OK.

I thought, well, do we know any more? I looked at some U.S. companies that do crowdfunding lending. There is a company called Prosper that does. There is AngelList, which does Regulation D or accredited investor crowdfunding out of California. And there is a U.K. company that does micro lending. I went to all of them. They all said, "We have had zero fraud."

So we can get more into the details of this, but the bottom line is it seems like these intermediaries, kind of like eBay, do make these things work. There are some specifics in my written testimony that I would like to refer people to about exactly how we do it, but I do not think that is the big point. The big point is let us get this done. Let us get a compromise that works for everybody and change the way the country works.

Thank you very much for your time.

Senator BENNET. Thank you very much for your testimony.

Lynn welcome. We will hear your testimony now.

STATEMENT OF LYNN E. TURNER, FORMER CHIEF ACCOUNTANT OF THE SECURITIES AND EXCHANGE COMMISSION, AND MANAGING DIRECTOR, LITINOMICS, INC.

Mr. TURNER. It is good that both of us are from God's Country.

Mr. ROWE. Aren't we all from God's Country?

Mr. TURNER. I will leave that one alone. But it is good to be here. It is an honor to be here again.

As some of you know, I have been a founder of a venture-backed startup company that was highly successful, that did create jobs. I have been at the SEC. I now serve on the Board of Trustees and Investment Committee of a $40 billion fund that does invest in this market through investments in venture capitalists. So certainly important to all of us, and I think everyone in the room would agree that the more jobs we create, the better off we are.

Having said that, though, I would like to talk about some of the things that bring us here, and I think some misnomers that in general the IPO market is off because of regulation, and let me quote from Goldman Sachs, which is in the written testimony. "Legal and regulatory factors probably do matter, and policy reform might strengthen New York's competitiveness. Nonetheless, we do not see them as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more."

I think that is borne out if you look at the charts on page 3 and 4 of my written testimony. The IPO market has always tracked what is going on with the general economy. When the general economy is doing well, we have a good, vibrant IPO market. When the general economy is not doing so well, it has not done well. This includes at times in the 1970s, 1980s, and 1990s, all before Sarbanes-

Oxley was ever passed. So it certainly has nothing to do with the issue of SOX in that regard.

In fact, if you look at the London AIM market that everyone mentions or points to, in Charts 5 and 6 and 7, you will see that in London they have had the same drop—in fact, their drop has even been more dramatic in London in the lightly regulated A market than it has been here in the United States. In fact, as we heard in the testimony from Renaissance Capital, the bottom line is people invest in IPOs when they think they can get a decent return. If you cannot get a decent return out of that company, people simply are not going to invest in them. Why should they?

In fact, in the London AIM market, if you look at the statistics on page 7, you will see that since that market was created in 1995–96, if you put $1,000 in it at that point in time, you would have $700 to $800 of that left, while the other components, the more regulated components of the London market gave you 50 to 250 percent return.

Perhaps more compelling is the chart on page 8, the venture capital returns. It highlights the great growth that came along with the IPO market in the 1990s, and keep in mind, the 1990s was a once-in-a-lifetime economic event. The economy has never done as well before, and it has certainly never done as well since the 1990s. And that IPO market during the 1990s is not necessarily something that in its entirety we want to replicate. In fact, when I was at the Commission, we had the leadership at the Business Roundtable come and meet with Chairman Levitt and myself at the time, and they were very highly critical of that IPO market because of misallocation of capital and losses that they thought it would bring and, in fact, did bring.

What the chart on the venture capitalists shows is, quite frankly, our bigger problem, as Goldman suggests, is infrastructure. We have not invested in this country in the infrastructure that creates the opportunity for these small businesses to grow, become successful, then get capital, and then even grow further. Things such as the incubators—and I myself have served in two incubators—are very critical.

Education, which I know is very near and dear to Senator Bennet's heart, as McKinsey said a year ago in a study, our investment in infrastructure which gives these companies the people they need is a serious shortcoming and has caused a real problem with these companies being able to get the talent and the issues we have in this country with the visas and being able to keep and retain really talented people who have come here and got their education, really hurts and impacts these companies as well, far more than the regulatory issues, just as Goldman Sachs mentioned.

So, with that, let me just make a couple points on the bill.

One, on page 13 it shows this bill will affect 98-plus percent of IPOs, so this is a fundamental shift in the regulation of IPOs. This is not for a portion. This is almost for all of them. It will be an impact for a long period of time. Five years is a very, very long period of time.

The stuff on the control stuff, let me just close by saying good companies have good controls, and the stats, as the written testimony shows, it is very, very clear we get higher returns when we

can invest in companies with good controls, not bad controls, and you are taking that transparency away from us as an investor.

With that, thank you, Mr. Chairman.

Senator BENNET. Thank you, Mr. Turner, and thank you to all the witnesses.

I would ask the clerk to put 5 minutes on the clock, and with that, I will turn it over to Senator Reed.

Senator REED. [Presiding.] Thank you very much, Mr. Chairman, Mr. Chairman, Mr. Chairman.

[Laughter.]

Senator REED. Mr. Ranking Member, Mr. Ranking Member, Mr. Ranking Member.

Senator BENNET. Your Excellency, Your Excellency.

Senator REED. Yes, yes.

I apologize. I had to go down to the Armed Services Committee. General Mattis and Admiral McRaven are down there on another topic equally as challenging as crowdfunding and Regulation A.

Professor Ritter, you have done a lot of work on IPOs, and the sense I had from reviewing your testimony is that there are, as you say, numerous factors to support the idea that small companies are not going public, being small is not best, whether private or public, particularly in this international marketplace. And it goes, I think, to some of the themes that my colleagues have spoken about with respect to even if we do make these changes—and many of them are very thoughtful—is that going to have the impact we desire because of these market structure issues? And you might elaborate on what these issues are.

Mr. RITTER. In terms of the market structure issues, are you including analyst coverage and smaller bid-ask spreads?

Senator REED. Analyst coverage, smaller bid-ask spreads, not having markets, secondary markets in some cases for the stock, employee stock. There are a whole bunch of issues, but you might be best to define what you think the most important ones are in commenting.

Mr. RITTER. Yes. I think that there are a lot of tradeoffs, as the Committee is fully aware, between lowering the transaction costs, the compliance costs for companies, but still providing protection for investors. And as has been pointed out in the testimony of others here, having intermediaries who can do some vetting and potentially protect investors, protect investors from themselves, might be a good way of allowing some small companies to get access to capital without needing to go through formal angel investors, formal venture capital firms. When there are no protections for investors, it seems there are just too many con men and too many unsophisticated investors.

But as the example of eBay has shown and crowdsourcing in the United Kingdom, sometimes intermediaries that do some of the vetting that have some things at stake can protect investors. So one possibility might be to put restrictions in some of the laws that require the use of certain intermediaries as a way of keeping out the fraudsters and possibly allowing a couple of years of experimenting to see does this work, and kind of go from there. Maybe it will not work, and hardly any capital will be raised. But maybe

it will turn out to be a lot more successful than some people might expect.

Senator REED. I think your response raises three issues, and I will sort of put them on the table, and I might ask anyone else who wants to respond.

One is that it presumes that the issuer is going to provide adequate disclosure to either the retail buyer or the intermediary.

Second, if you have an intermediary structure, somehow it is going to have to police the intermediaries to ensure that they are really working on behalf of the investor and not on their own behalf.

And then a lot of the issues we will talk about in the context of this legislation is, well, so what liabilities are on each of these different actors? Is it a very loose negligent standard, we tried our best, did not quite get it? Or is it much more significant? And those are some—and I have just seconds left, so, Mr. Rowe, could you respond? And then perhaps Lynn, but very quickly.

Mr. ROWE. Just very quickly, I think Professor Ritter said it well. I think intermediaries should be required as I believe the Bennet, Merkley, and Brown bills do require, and I think that that has shown that it does block fraud.

Senator REED. Mr. Turner?

Mr. TURNER. Senator Reed, I would probably put a strict liability on that, and probably to establish accountability, I would put a fiduciary standard on that intermediary, a reasonable fiduciary standard. We do not want to go overboard here in that regard. In some of the information I provided the Committee, though, there is a paper by Professor Jay Brown from the University of Denver that gets into the issue of provisions for bad actors in the intermediary or one of the other roles. I would certainly turn around and take a look at that because I think that is one piece—there is some good stuff in these bills, but I think the lack of accountability is what is driving a lot of investors and consumers batty about these bills. They do not see it. So I think you have got to get the bad-actor provisions and you have got to get the liability and the fiduciary standard in there, or it will take us back to the bucket shops and penny stock frauds.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Senator WARNER. [Presiding.] Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Senator WARNER. I know. I am not even going to get a couple comments in. Senator Corker.

Senator CORKER. If you would like to make comments——

Senator WARNER. No, no.

Senator CORKER.——in advance of a lowly minority Member, that would be fine.

Listen, we thank all of you for your testimony today, and I think all of us care greatly about access to capital and ensuring that our economy flourishes, and I find this testimony today very interesting. I was most interested in the beginning on the scale issue that was brought up regarding larger companies having greater returns than smaller companies. Mr. Waddill, since you sort of represent the smaller-company issue now, and Professor Ritter was re-

ferring to that, do you have any comments regarding why that is the case?

Mr. WADDILL. It is probably tied to the fact that we all want to be bigger companies, right? I think what is really important to point out is access to capital. Without that access to capital you cannot be a big company. You cannot get through—and I certainly hope that the 1990s were not a once-in-a-lifetime thing. I look back at the companies in my industry that were successful going through the 1990s, the biggest one being Genentech, a venture-backed company that got early access to capital, became one of the biggest biotech companies in the world.

Senator CORKER. And conditions have changed since that time so that Genentech could not have done that in 2012?

Mr. WADDILL. Certainly in the past 10 years, conditions have changed. Part of that, you know, you have to pay attention to—and I agree with what Lynn was saying—what happened in the economy. But what is another portion of this—and I can state as a CFO, an informed investor is a good investor. I want them to be informed because then they can get in lockstep with me and what I am trying to do. But I think there needs to be an appropriate balance in that.

If we look at the past 10 years of the ups and downs in the economy, certainly IPOs have tracked along with that. But with this legislation, what is really being proposed is to unleash the access to capital. And as the economy comes back in an upswing right now in what clearly in my lifetime is the biggest financial crisis that I have seen, unless these burdens of compliances and these costs of compliances are loosened, you know, over, say, that 5-year period, this is going to be an anchor. It is going to be a negative factor, a negative multiplier that is going to prevent us from really growing jobs going forward in an appropriate way.

Senator CORKER. Mr. Ritter, U.S. PIRG, I guess, has mentioned that reducing compliance costs, meaning people not exactly knowing what they may be purchasing, will actually increase the cost of capital. I wonder if you might have any comments regarding that.

Mr. RITTER. It is certainly possible that investors are going to demand higher promised returns if they have got greater concerns about having lack of transparency, having more bad apples in the barrel, that the good apples wind up subsidizing the bad apples. There are costs of compliance, and getting that balance exactly right in terms of imposing costs on all of the apples to reduce the number of bad apples does involve difficult balancing issues.

Senator CORKER. Mr. Turner, you mentioned the need right now for greater infrastructure. That is more important: incubators, education, visa issues, which I think many of us up here agree, especially on the visa issues.

What was it about the 1990s that—I guess we were doing far less of that at the time. What was it about the 1990s, in your opinion, that caused IPOs and just the economy in general to flourish, whereas now we are looking at a lot of micro issues here to make that happen?

Mr. TURNER. Thank you, Senator. There were things going on. There was an increase in debt that was occurring over that period

of time that was funding increases, if you go back and look at the issuances of debt and the debt that individuals, households, and companies were taking on, were financing a fair amount of that growth, even at a national level, as everyone knows these days, through an acquisition of debt; whereas, now we are in a more austere environment, if you will.

There was probably also an environment, as you saw, the high-tech industry, which really only came about at about the end of the 1960s, early 1970s. You really saw the tech industry as an industry as a whole take hold and grow. We had a phenomenal amount of manufacturing still going on at that point in time, but as we reached toward the end of the 1990s, we started outsourcing. I was an executive in a large high-tech company at the time. Quite frankly, we started out first with much more manufacturing. We started to take a lot of our technology offshore as we came to the end of that decade. And as we did that and we stopped building the debt—or, you know, people started maxing out on debts, it has put us into the current economic situation we have now.

So two vastly different economies, not only here, if we look around the rest of the globe, as the charts on London show, you had the same effect going on in other countries. And, of course, this decade has seen the growth of emerging markets like India and China. And some of that and the success of the markets is due to the fact that at the Commission we spent a lot of time, at the urging of this Committee and others, to go educate everyone else on how to build really good capital markets. And everyone else went and really built good capital markets. And if you have ever sold stock in a market, you know that it is best if you sell the stock in your home market with your home investors because that is where you get ultimately the greatest turnover in your stock and the greatest ownership. If you were doing a sale of stock in a U.S. company today and you went to the Japanese Mother market, 6 months later all those shares would be back trading in the United States, so why do it anyway? Well, it is the same thing for Chinese and Indian companies. When they list, they tend to list on their own markets. They have got good markets now that they did not have before. So there is a reason they go to those markets, and we have to be very particularly sure in that case, because of that, that we keep our market the most competitive, and that means it has to give the highest return to investors. In our $40 billion fund, we will put that money wherever we have got to go in the world to get the highest return for the half million people in Colorado because they depend on that money when it comes to retirement.

And so if someone else is able to have more transparency and higher returns, we will go there, and we have gone there.

Senator CORKER. Mr. Chairman, thank you. I think you performed in an exemplary manner as Chairman, and I just want to say that I appreciate the efforts of so many on this Committee to create additional access to capital. But it seems to me the big issue that so many people, again, at this dais have worked on is getting the macro issues right, and if we could deal with some pro-growth tax reform and entitlement reform and deficit reduction, many of these issues that are being dealt with in a very micro-targeted way

would go away, and that the market would function very, very well. And I appreciate your leadership in that regard, too.

Senator WARNER. Thank you, Senator Corker, and I am anxious to get to my time. I will call on Senator Tester next, but I would just make the comment that the appropriate role for intermediaries, but the intermediaries as trusted intermediaries in the late 1990s, I am not sure that that track record in terms of the ultimate result of a lot of those companies ended up being a great value-add for the investors.

Senator Tester?

Senator TESTER. Yes, thank you, Mr. Chairman, and I appreciate that perspective. I also want to thank Senator Corker for his comments about the work that the Members of this Committee have done—I very much appreciate that, too—to craft proposals that really will, I think, help small businesses grow through access to capital.

Let me say at the outset I am very pleased with Senator Reid's announcement about the consideration of a package of capital formation bills in the near future. I know you are working on one, too, Mr. Chairman, and hopefully we can get something to the floor that is going to work and get it passed in a bipartisan way.

It is really an indication of the good work that is being done here on the Banking Committee, important legislation to open up markets for small businesses under the leadership of Senator Johnson and Senator Shelby.

This Committee has seen some partisan battles in the recent past. We have been able to set those differences aside on several bipartisan bills that have the potential to become law, I think create jobs, and can happen this year, and I hope we will move forward and focus really on results instead of politics.

Members of this Committee and Senators Reid and McConnell I looked forward to working with to put together a bill, passing it on the floor, and I am confident that with some strong leadership we can get a package of legislation signed by the President.

It is good to see Senator Toomey here. We have been working on legislation since July when I had an access-to-capital hearing in my Economic Policy Subcommittee. The key takeaway from that hearing was we need to ensure the capital markets within the reach of startups at various stages of their development, particularly in the stages before they are ready to go public.

As a result of that hearing, we had a chance to take a closer look at updating Regulation A and better enable small businesses, including many of the innovative biotech firms in Montana and Pennsylvania and around the country, to raise capital through these public offerings. These capital-intensive firms face unique challenges in raising the significant amounts of money necessary to complete clinical trials and complete development of cutting-edge drugs. Mr. Waddill talked about that in his testimony, and I appreciate the partnership we have had working on this bill, a bill that passed the House 420–1. It makes a number of updates to Regulation A, increasing the amount of capital that can be raised through these offerings to $50 million, while providing a host of new additional investor protections that include a requirement of annual audited financial statements, and the bill provides the SEC with the

ability to require issuers to provide additional information regarding the financial condition of businesses to prohibit bad actors from participating in such offerings.

The bill maintains the most attractive elements of Regulation A, including the ability of issuers to test the waters before registering with the SEC, and preserves the nonrestrictive status of securities sold through Regulation A offerings, a bill that, along with many others, I hope we can get passed here in the U.S. Senate.

My first question is for Mr. Waddill. In your testimony you talk about the opportunity that modifications to Regulation A present to startup biotech firms. Can you talk a little bit about how and at what stage of development a firm like yours might use Regulation A and what an adjustment of that cap from $5 million to $50 million might mean for your company?

Mr. WADDILL. Certainly. So OncoMed is a biotechnology company. We are doing discovery and development work on cancer therapies. We are currently in clinical trials. Clinical trials are extraordinary expensive. For every patient that is in a Phase I—and there are three phases of the clinical trial process. For every patient that is in Phase I is approximately $50,000. Get to Phase II, it gets to be about $75,000. So to access $50 million when I look at my company's plans, that would get me from discovery for a therapy to the end of Phase II.

Now, the end of Phase II is a very important marker, milestone, because that is when you reach what we call "proof of concept," where you have shown that your drug has potential to move forward into Phase III, but the science that you have been working on for a number of years has gotten to that point.

Now, in terms of would my company try to access $50 million time and time again, the answer is no because what I have to be cognizant of is when I raise $50 million, my previous shareholders are getting diluted a little bit. They own a little bit less of the company when I raise that money. So we try to be very strategic when trying to go for those sums of money and direct them specifically to what we think are the promising therapies within our pipeline.

Senator TESTER. I think your testimony also said it was 1991 it was set at $5 million, and I do not know how long you have been in the business, pharmaceutical business, but——

Mr. WADDILL. Twenty years.

Senator TESTER. Well, we are there, then, 1992.

Mr. WADDILL. Yes.

Senator TESTER. How have the costs increased since then? In other words, $5 million I would imagine in 1992, as in agriculture, bought you a hell of a lot more than it is going to buy you today.

Mr. WADDILL. Yes, absolutely, the difference being—and this gets a little complex—that the recognition in the marketplace of what is valuable has changed.

Senator TESTER. Yes.

Mr. WADDILL. So back in the 1990s, when I first got into biotechnology, you could have $5 million, go for a couple of years, and shareholders would respond to the value you created with $5 million. That has changed dramatically in that you have to not go from just discovery but all the way to the end of Phase II before they will look at you.

Senator TESTER. Got you.

Mr. WADDILL. And that is a key understanding in all of this, that the data that flows through my financial statements talk about what is going on financially in the company. We disclose everything appropriately, but the science underlying it is really as important, if not more important.

Senator TESTER. Just a little liberty, Mr. Chairman.

You can make this answer very, very concise, if you would. There is some anticipation that people would use this offering multiple times. Could you talk about that very briefly, if you see that as something that your company would do, or if it is something we need to be concerned about?

Mr. WADDILL. No, that would be dilutive to my current shareholders, and I would not have a job.

Senator TESTER. Got you. Thank you very much.

Thank you, Mr. Chairman.

Senator WARNER. Thank you, Senator Tester, and thank you for your leadership on this issue. It seems to me—now when I get to my turn, I will speak a little bit about the fact that there is a lot of commonality amongst a number of these bills. I know Senator Toomey has been very active on a series of them, and this sure ought to be one where we could find some common ground and a broad bipartisan bill as opposed to a Democrat and Republican alternative.

Senator Toomey?

Senator TOOMEY. Thanks, Mr. Chairman, and I do appreciate your interest and leadership in this, as well as that of Senator Tester. You know, when we go back home to our respective States, I am sure we all hear the vocal complaints, legitimate complaints, from our constituents about how little is getting done, how little we work together, how this place has devolved into this partisan battling that has been downright counterproductive for our economy and for our country.

I really believe that we are on a topic here today that is a complete exception to this entire idea. And since I got to the Senate a year ago, I have been delighted to work with colleagues on the other side of the aisle to advance bills that are very broadly, almost universally supported, and I think it is time we move on this. I am, frankly, delighted that we have got a strong interest in the House to move a series of bills. I am delighted that there is interest here.

If ever there was an opportunity to do something that is unambiguously constructive for the economy, pro-growth, good for job creation, this is it. And an awful lot of the heavy lifting has already been done.

So, really, I am glad we are having this hearing. I hope this is to drive home this message that now is the time to move.

Senator Tester referred to a bill that he and I have together that passed the House 421–1. We have many cosponsors on both sides of the aisle. I have a bill with Carper—it is known as the "shareholder bill"—that would limit the permissible cap on the number of shareholders. It passed the House Financial Services Committee, which is a big committee, by a voice vote in October of last year. It is my understanding some version of that will be included in the House package.

Then there is the bill S. 1933 that I have done with Senator Schumer, which the nickname for this is the "on-ramp bill." This one, of course, would facilitate an IPO by diminishing some of the burdens of registration that currently attends to an IPO. This bill passed the House Financial Services 54–1. These bills, if not every one of them certainly the first and the last, are supported by the President in part of the Startup America Plan. So I hope we will move on this very soon.

My quick question for Mr. Waddill: One of the things that has been stressed to me by some of the folks in the life sciences in Pennsylvania is how critical the multiple stages of capital raising is, from infancy right through IPO, and there are a lot of pieces, a lot of steps along the way.

It seems to me that if you facilitate access to capital at any step along the way, let us say even the IPO, you increase the opportunity and the chances and the ability to raise money at the earlier stages because one stage in many ways depends on subsequent stages.

So could you comment on whether you agree with that, whether that is, in fact—and, in other words, if you facilitate raising capital at one stage, are you really helping that company out throughout its entire life cycle?

Mr. WADDILL. Oh, there is no doubt about it. I can tell you 10 of my 20 years in the industry was spent consulting and help start 34 different companies, some of those in Massachusetts, some of them in California. And predominantly they were the early stage companies, predominantly venture capital-backed. And those early stages, to raise $5, $10, or $15 million to establish a lab in biotechnology was just absolutely key. You cannot progress the science forward unless you set up that infrastructure.

So it is remarkably important, and you can connect the dots between the later-stage raise and the earlier-stage raise. And if you get a high-quality investor in that process, they will stay with the company for a period of time because they will believe and understand what you are doing.

Senator TOOMEY. So would it be your judgment that if we passed some package of these bills, that could actually facilitate angel investment, early venture capital, even in respects that are not directly addressed by the bills?

Mr. WADDILL. Yes. So when you look at venture capital investing, part of their collective problem right now is they have no exit for their investment. They cannot cash out. And that is due to economic climate and the barrier to go and be a public company. Part of that barrier is the cost of compliance. I am a numbers guy, so I can share some numbers with you. For my company to try and prepare for it Sarbanes-Oxley compliance would be somewhere between $3 to $3.5 million. On an ongoing basis, if we use the SEC study that came out, the medium cost to comply with 404 is in the $400,000 to $450,000 per year range. So an easy way to think about that, for every $1 million of compliance, I am prohibited, because I do not have the funds, to hire 15 to 20 scientists—those 15 to 20 scientists will be key in developing the science further—and, more importantly, another 15 or 20 patients that I cannot treat in

the clinic. For us to be successful in our sector, we have to be treating patients to progress forward.

Senator TOOMEY. Mr. Chairman, if you would just indulge me for 1 second, I notice Mr. Rowe seemed to have something to indicate. If you want to respond to this question, I would appreciate it.

Mr. ROWE. Yes, I do. I spent part of my time with New Atlantic Ventures, which is an early stage venture capital firm. One of the things that we're seeing is that the exits that are prevalent today are primarily acquisition as opposed to IPOs. There is much less upside for a venture capitalist if you go down the actual path. And, incidentally, unlike in IPOs where it is somewhere between a 60-percent increase and a 5-fold increase, depending on whose data you look at in jobs, typically after acquisition you let go people because there are redundancies. So this is very important to the venture capital industry.

Senator TOOMEY. Thank you very much, Mr. Chairman. Thanks to the witnesses.

Senator WARNER. And thank you for your leadership on these issues.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman, and thank you all for your testimony. I had two lines of questioning I wanted to ask.

One, how should we address the counting of beneficial owners of stock rather than owners of record? In my own view, I think it makes sense that we should be counting beneficial owners and raising the threshold to a higher number, and not necessarily be counting a broker of record that has stock from many shareholders as a shareholder. But I would be interested in hearing some of your views.

Mr. WADDILL. It is a cumulative number. I agree with you that the number needs to be raised. I am not sure what that number is. I can tell you that one of the predominant issues in my industry is that we compensate employees with stock options. We do that from the president of the company down to the glass washer in the lab. And over the course of time, a lot of shares will be issued to a number of people. So that is another cumulative set that needs to be added to what you are addressing.

Mr. RITTER. Senator Menendez, I am in complete agreement with you that the regulations do need to be changed given that the concept of shareholders of record is dramatically different now than it used to be because individuals for public companies are holding stock in street name. Now if you have got a company that before going public might have had 1,000 beneficial shareholders and after going public has 2,000 beneficial shareholders, the shareholders of record might have only increased by 10 people. So the regulations do need to be changed to reflect stock being held in street name.

Senator MENENDEZ. Anyone else? Ms. Smith.

Ms. SMITH. Yes, I would add to that that I think that the ability to do online activities has helped us so much, for example, with disclosure. EDGAR enables information to reach the hands of investors so elegantly and has made such a big impact on transparency.

However, when it comes to the private placement market, the issues that we have, even with the 500-shareholder rule, actually developed because of the ability to connect online with investors of all kinds, and hopefully they are all qualified. We have had a situation where Facebook, for example, even under the 500-shareholder rule, has benefited from a lively trading market in its stock at prices that have valued the company before they filed for the IPO, something over $80 to $100 billion, the size of McDonald's. A major company that can then have the benefit of this lively trading market beyond any of their existing employees but involving outside shareholders and yet not take on the responsibility of full disclosure.

So with these rules on the numbers, it appears to us that it is not the number that—with technology, 500 may even look like a big number because we can move information around very quickly among a lot of people. That the real issue is to target the smaller companies and to put some kind of a market cap limit. For example, if the company's market valuation is below $300 million, and below $300 million in total valuation, and it gets to 500 shareholders, fine, we can have this market. But if it goes beyond that, we then do not want to establish what I would call a shadow IPO market of major companies that should be disclosing and yet accepting the ability to have a lively trading market in their stock. A shadow IPO market is probably not in the best interest of promoting a strong IPO market here in the United States.

Senator MENENDEZ. And a final question, Mr. Waddill. You mentioned in your testimony a number of avenues where financing could be potentially raised by small private and public companies, and in 2010, Congress passed my therapeutic discovery project tax credit. My understanding is your firm was awarded credits through the program.

From your experience, can you talk about whether you found this program beneficial, for example, small biotech capital formation? And do you believe that an extension of the credit would help other small innovative biotech firms as they compete against competitors around the world?

Mr. WADDILL. Absolutely. So we applied for five, we got five. That equated to $1.2 million into my company. And I can specifically tell you that we had—we did not have funds to progress one of our therapeutic areas, and that $1.2 million provided that. So as I sit here today, that for us is a major initiative in the company which just would not have happened. And it was one of several areas. So if you equate that to a smaller company than mine, certainly it would have been beneficial to advance the technology, so it was a tremendous help.

Senator MENENDEZ. Thank you, Mr. Chairman.

Senator WARNER. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you so much for holding this hearing. I wanted to associate myself with Senator Toomey's remarks. This is a place, I think, where there is very broad bipartisan support and that we ought to figure out how to advance these bills in a bipartisan way. So much of the debate that we have around this place is this left-right discussion that no one at home really understands and, frankly, find meaningless. And we

are at a position now, I think, where as a Congress we can actually support what is the most innovative economy in the world still and drive this innovation in a way that actually is promoting job growth here in this country and promoting wage growth in the country, the two biggest issues that the people that I represent face, frankly. And as the testimony pointed out, we are at a moment in the economy where the productivity increases, the productivity gains that legacy firms have achieved, which is great, are not driving the job growth that we need, and it is going to be the company that is founded tomorrow and next week and the week after that that is actually going to drive job growth.

The other point I want to make before asking one question is the critical importance that education plays in all of this. You know, the worse the unemployment rate ever got for people with a college degree in the worst recession since the Great Depression, the recession we just went through, was 4.5 percent, and there is a reason for that. And if we are not educating the people in this country to be able to do these jobs, the capital formation that we are all talking about here is going to go someplace else to find human capital that actually can drive these new businesses. So that is not within the jurisdiction of this Committee, but it is a very important part of what we are dealing with.

Mr. Rowe, I appreciated very much your comments about crowdfunding, the bill that Senator Merkley and I and Senator Brown have been working on. I wonder if you could talk a little bit about what kind of businesses you would expect to take advantage of crowdfunding if we were able to pass this. Is it just somebody who has got an initial idea, existing small businesses, someone who has got the need for additional capital? And then, finally, as we look to formulate a consensus bill on crowdfunding, which I believe we can do, you know, what thoughts do you have about the lessons that we can learn from existing Web sites like Kickstarter, which you mentioned in your testimony, which has enabled individuals to donate to film production and the arts? So run with it.

Mr. ROWE. Thank you, Senator Bennet. I really appreciate your question and the whole Committee's time again.

Let us put sort of the potential of this in a little bit of perspective. Apparently, Americans save in long-term savings about $30 trillion. This is 401(k)s, you know, pension funds, IRAs and so forth. Author Amy Cortese framed this by saying if Americans took 1 percent of their saving and put them into—instead of saving it in a 401(k), invested it with another business somewhere in their town, just 1 percent of their money, that would create a pool of money 10 times bigger than all the venture capital that we invest every year in this country. It would create a pool of capital that is half as big as all outstanding small business loans.

So the size of this, just first of all, is simply huge, and the Kickstarter analogy—this came out I think in Talking Points Memo recently, and there was some debate about the accuracy of the figures, but I think they really nailed it now. They found that Kickstarter, which is one crowdfunding site that instead of investing, you get a thing, to kind of work around the laws today you get an item from the person you are investing in, you do not get equity. Kickstarter raised for the arts alone half as much as the NEA, the

National Endowment for the Arts, raised for arts last year in 2011. And they are predicting that in 2012 it will tie the NEA in money raised for the arts. This is everything from video games to film to paintings and so forth. So the impact of this, just the scale, is huge.

I predict that this is going to be your everyday business. I think that you are going to have somebody in your community who starts a catering business, and they are going to go on Facebook, and this is the general solicitation part. This is why that is important, because if you post on Facebook that is a solicitation and it would be illegal today. They are going to go on Facebook, and they are saying, "I am starting a catering business." They are going to go to their friends from college and say, "Would you back me? Would you put 500 bucks or 250 bucks in to help me get this thing going? I need to buy an oven." That is the kind of business that I think this is going to really—this is where it is really going to hit the ground running. And where it really is different from what, you know, for instance, happened in the late 1990s with the IPO boom and the venture capital, that happened in a very small part of the country, in a very small type of business. The rest of the country did not see those benefits. I think we are talking about something which is timeless and which is growing. So that is the first part.

If you are interested, I do have some very concrete suggestions, having talked to dozens of people about your bill and other bills. I think there is a potential for a compromise bill here that is 99 percent what is already in all the bills, and there are a couple little tweaks that people would like to see, or we can come back to that afterwards.

Senator BENNET. Great. My time is up, but I for one would love to hear those suggestions, and I am sure that Senator Merkley would as well.

I just think the last point is so important. These initiatives will inject capital throughout the country, throughout the entire geography of the country, in a way that we have not seen before. This really is about Main Street, and we need to do everything we can do to make sure we protect the investors that will come. But I think the potential here is just enormous, so thank you, Mr. Chairman.

Senator WARNER. Thank you, Senator Bennet.

Senator Merkley?

Senator MERKLEY. Well, thank you very much, Mr. Chair, and I will follow up by saying I had highlighted in your testimony, Mr. Rowe, the comment about the $30 trillion. So I think it is a reminder of the potential, and that is just retirement savings.

As we wrestle with the crowdfunding platform, the goal that I brought to this, and my colleagues who have joined me in the bill, is to establish a successful system, because if it gains a taint of fraud on the front end, it will be very hard to improve on that in the future. And one philosophy we brought to that was portal neutrality, so the portal itself is not involved in any sort of pump scheme that might discredit its legitimacy.

A second was accountability for accuracy among the officers and directors, and I know you have made the point in your testimony that maybe that is going too far. I think that is an important conversation for us to have, at least at the startup of this, and as we

search for a way to try to give folks confidence that what they are reading is accurate.

And the third was having statements reviewed under 500K and audited over 500K as three of these approaches.

But I thought I would just invite you to share your concern that the accountability for accuracy might be going too far. And, Mr. Turner, I think if you would like to follow up on that, I would appreciate it.

Mr. ROWE. Thank you. So on the accountability, I think we are very close. I think the definition you used in your bill is almost identical to the—and I am not an expert in this, but the SEC Rule 10b–5, which Lynn probably authored, which defines the accountability for fraud in private exempt offerings of securities today under the SEC. It is identical to yours with one exception. They do not hold the officers liable if there was no intent of malfeasance or negligence. So in the basic standard in the bill today, it just says if you misstate something, then you are liable. And we are concerned that if you have got 100 investors and one of them gets made at you because of, you know, maybe a personal dispute or something, they sue you ad you are liable because you accidentally misstated something, we are hoping that would not be included. The standard SEC fraud clause works fine. It just says you are liable as long as you did not—as long as there was malfeasance, or I think they call it—you are probably going to be able to do a better job with this.

On the other bits, I think that reporting is great. There was some suggestion that maybe reporting should be quarterly. Again, for these small businesses it would be really great if that could be annual. I mean, this is a catering business. They do not do quarterly accounting typically, and it is an extra cost. It is that kind of level of tweak that we are really talking about. I do not think we are in disagreement at the overall level.

Senator MERKLEY. Thank you very much. I think it is very helpful to chew on these things.

Mr. Turner, do you want to make a comment on that?

Mr. TURNER. Thank you, Senator Merkley. In general, I like the notion in your legislation that there is a degree of accountability. I think it needs to be more than just an intent-based thing. If, in fact, you go out and mislead people, you ought to be held accountable. And on the flip side of that, if you are the intermediary representing someone trying to raise the money, then I think you ought to have a fiduciary standard to that investor that you are held to. And I think it goes beyond just being something with scienter or fraud. I think that if people recklessly go out there and exhibit gross negligence in doing this and misrepresent things, certainly those people should be held accountable. If it is merely an oversight, you know, I do not think an oversight, but, nonetheless, there is a danger to the system here. We have a very good history with these types of situations in the past, as recent as Congress did the penny stock fraud reform act in this building.

So we have a history that when people are out attracting this type of money, unless you have a fair degree of accountability so that investor can go recover, you turn around and create a situation where there will be damage done and people withdraw from

doing these. Rather than increasing them, you are going to decrease them if we go back to the whole penny stock frauds or bucket shop days that we have had a couple times. We have tried this a couple times, and it never worked. So if we are going to try it a third time, you have got to build in transparency, you have got to build in full disclosure of conflicts, and you have got to put in a decent level of liability if you take people's money and misappropriate it or mislead them on it.

Senator MERKLEY. So, Mr. Turner, I am running out of time, but I will look forward to following up with you on this issue of platform fiduciary responsibility, because I think we had really worked to frame this as a facilitator rather than a vetter, and I think a couple alternative perspectives are being presented here to chew on.

Mr. Chair, can I extend for a moment here? Yes, Mr. Rowe?

Mr. ROWE. Yes, I think that probably the word "vet" is the problem because it could mean different things to different people. What seems to be working well is where the facilitator does background checks, makes sure that the offering descriptions are very complete, does a bunch of other stuff to make sure that these are not fraudsters; but does not try to say this is a good catering business or a bad catering business. That is the line that I think they should not cross. And I think that is also what you are saying as a facilitator.

If you look at AngelList, which is working very successful now under Regulation D for just accredited investors, they describe the offerings. They also do clever things. They describe well-known people who are investing in these things, well-known people in the community that have already privately vetted them, and they say, you know, if Mitch Kapor wants to invest in this—they do not say this overtly. They say, "Here are the people who are investing. You draw your own conclusions."

So there are very clever ways that they can get the intermediary without actually directly vetting can facilitate and prevent fraud.

Senator MERKLEY. Mr. Chair, I have two more questions, if we have time.

I want to throw both of these out there at once. One is that another challenge for small investors—because they are looking at the front end, and they figuring in a couple years this company is going to sell out or be purchased or is going to merge. How do you ensure that there is some protection for the small investor who is so key in the success on the front end, but the deals struck by management when they sell the company might basically undermine any return to that small investor. So that is one question.

A second is: Should there be the possibility for intermediary funds? For example, let us say I think it would be quite interesting to put 1 percent of my retirement funds into small companies, but I have no time or desire to vet those companies. Should I be able to put 1 percent of my money into basically an intermediary fund that would then invest in crowdfunding?

So I will throw those two questions out for any thoughts or insights you might have. And, Mr. Ritter, I think that you might want to start, or if you would like to start, related to this issue of protecting the small investor when M&As come up.

Mr. RITTER. Right. In regard to your first issue, with a lot of startup businesses, they fail, and investors, I think, will certainly be aware that there is a possibility of failure. But there is also an issue, what if the company is very successful?

One possible thing that could go on is the small investors wind up *ex post* being diluted out. For instance, the first-round financing might be Class A shares, and then later on some venture capitalist or brother-in-law of the entrepreneur comes in and is issued Class B shares that have conversion rights of 100:1 into Class A shares. So the company is very successful, but the original Class A investors wind up owning 0.1 percent of the company and they do not get to share much in that upside potential.

I think that, you know, angels, venture capitalists, are aware of these possibilities. They insist on fine-print anti-dilution rights. A lot of individual investors are not going to be thinking about all of these concerns, and if they are talking about investing $1,000 in a company, it is certainly not worth their while to go out and hire a securities lawyer before they decide to invest this $1,000, to put the $1,000 in.

So one possibility might be to craft the legislation to have certain defaults, anti-dilution provisions or something as the base case that these Class A shareholders would have to vote to override if they are overridden.

Mr. ROWE. If I may, I do think it is a very valid concern, and I would say there are other concerns, similar concerns, such as if it does very well, what if it just does not sell the stock for a long time, does not make dividends. You know, when does this investor get out, for instance?

So this is why I believe that you should require intermediaries, and I know you do in your bill. The intermediaries will compete to be attractive to these small investors. What is already happening in England is that they are looking at—the intermediaries are looking at putting in just such these provisions themselves in order to be more competitive to draw small investors. I think this actually is an area where we can leave the intermediaries to figure out what is the best deal. How can we structure this with standard docs and standard provisions that will be attractive to these small investors? The intermediary who loses all the investments or whose investors hate it because they lost all their money will go out of business very quickly and I do not think realistically will set up in the first place.

Senator MERKLEY. Thank you. And I am way over my time, so I am going to return it to the Chair.

Senator WARNER. Thank you, Senator Merkley. And I want to also thank all the witnesses and all the good work of the folks on the Committee. This was my business for 20 years in the venture business, and I believe there is enormous opportunity here to jumpstart capital access, because, frankly, our recent efforts in terms of the small business bill and some of the other capital access bills have not been very successful.

I am very intrigued with the crowdfunding notions. I do think these questions around—having been that, you know, bad venture capitalist coming in at times, you know, there are real concerns about dilution interests, trying to protect those early stage inves-

tors. But the flip side is if the company is not doing well, the market drives some of this. So the question of how you get the intermediary right is, I think, an important one. I know Senator Merkley has been working on this.

Clearly, the intermediary in and of itself, though, we had very "trusted" intermediaries in the late 1990s, I am not sure all the products that were put out in the marketplace, you know, their performance record was obviously not that good. I still recall a number of companies I had that had, you know, momentary billion-dollar caps that went to zero as the tech bubble burst.

One of the things that I am—and I have great respect for Lynn Turner, but I do believe that the regulatory burdens of Sarbanes-Oxley, 404 and others, are stopping companies from choosing to pursue that route. And I think some of the bills that I've been working with Senator Toomey and Senator Schumer on, on the on-ramp approach, make some sense.

I would argue that one of the things that is different than the bucket shop era is that the power of the Internet bringing more and more transparency and being able to more quickly identify bad actors through this tool I think is something that might preclude some of this bad behavior, and I would just be curious to hear folks' comments on that. And, Lynn, I would love to have your rebuttal as well to that presumption.

Mr. WADDILL. Well, I can tell you from our company's point of view, when we look at the use of capital, it clearly comes into the equation. Do we want to spend $3 million ramping up into Sarbanes-Oxley compliance? Do we want to spend $2 million over the next 5 years, $1 million plus? Do I need to hire a couple more staff to support this internally? It comes up, because every dollar is precious.

One thing that is just fundamentally different than the crowdfunding—crowdfunding, they have a product. I am in an innovation stage where I am shooting for a product, and this is something that is interesting to cut across industries that when you are in that zone, when you are spending your capital to get to the point where you can make hopefully millions and tens of millions of dollars and build a company, that is when the funds are really critical.

Ms. SMITH. Just to comment on the power of the Internet and having a IPO market perspective, we can do much more. It may be outside of these bills, but we are not using the power of the Internet enough to help the IPO market, which is ultimately the end game for so many of these companies.

For example, in early IPO trading, we know very little about who owns the shares as soon as they are allocated and during the first days they trade. The transparency of our trading markets is extremely poor, which hurts and scares a lot of investors in the market. They do not understand the trading volatility. And I think we can use more transparency.

The ease of information when a stock ownership gets to be over 5 percent is poor. We should not have to wait for days to find out who owns that stock. So there is a whole lot we can do to make our IPO market better. And that is regarding the trading.

When it comes to information, I mentioned how important EDGAR Online has been to the market. There is so much more

that we can do. We file registration statements that are lengthy, and when they are updated, we do not know—we are not given a red line as to what the update is online. Companies' talk at road shows, why aren't they transcribed? Information is there, and it does not cost much to get it out to investors. And I believe that if we could add that kind of attention, it would help. The market is what it is—we are not going to be able to change too much. It is about returns. But the more information that we can give investors would help the IPO market that these smaller companies are trying to address.

Senator WARNER. Lynn?

Mr. TURNER. Senator Warner, we do totally agree that the Internet is bringing out more of the bad actors. The problem is, as we have seen it with the Chinese companies—and keep in mind, all these bills are applicable to the Chinese companies—is that the Internet is getting it out after the fact. So while it is good it is getting out earlier before losses can get as big as perhaps they might have been in the past, it is still water over the dam, and the money is gone. And so while it gets out sooner, it ultimately does not prevent the losses. So from that, it is not a workable thing. And as we have seen with the Chinese companies, that IPO market has totally dried up, and people went away from it because they do not trust it. No one is going to play at a Vegas casino, which is what that IPO market was.

As far as the SOX 404 stuff, yes, we would probably respectfully disagree on that point. SOX 404, I went through two companies, including a fairly new software company that had done it. I actually found that in the long run—one was Sun Microsystems. We found that we actually had tremendous savings from getting the company run the way it should be and the way it controls when we put that in. As the data in the testimony shows, companies that do not have those controls way underperformed the market, way underperformed their peers. And yet this year—I got an email just yesterday from a service that tracks this. They said something like 22 percent of the 2011 filers so far have reported problems with their controls, and there are a number of studies now underway to look at these IPO companies and see how long it is between the IPO and when we are all of a sudden seeing this, because you actually trade in the market. What we have found is you can make money, good money, as a trader in the market by trading against the companies that have the poor controls because they underperform versus the companies with good controls. So when I was at Glass Lewis, when we put out this type of research, we actually found funds trading on the data and making good money just by identifying the companies with poor controls. They do underperform.

So if a company goes public with poor controls, sooner or later it is going to impact on the stock. There has also been research that shows that that has a contagion effect now. It not only impacts that company, but it impacts the stock price of other companies in the trading, especially with all the trading and all that is going on today. And so especially given the fact—you cannot say SOX 404 cost you that much at IPO because it is not until the second annual report 2 years later that you are doing your first SOX 404.

We also know that a high percentage of these companies in terms relative, you know, are still not getting that fixed, so it is having an impact on them, and it is having an impact on the investors in those companies. And why is it that you are going to take that away? Why are you all of a sudden going to say in a situation where before you would have told me they had bad controls, now you are going to let them hide it for 5 years?

Senator WARNER. I would take issue. I do not think that the on-ramp proposals that we are laying out allow you to hide it. I think there are appropriate balance controls for these companies to ramp up. I do think having been on boards and investors in many of these entities, it is a burden and hurdle that slows the IPO market.

That brings me to my next question, which is, you know—and I would like anybody's comments on this. One of the challenges with a much more limited IPO market is not only the fact that less companies get access to that capital, but I think there is a competitive price our overall economy pays when companies are forced through their only virtual exit to be a merger and application. I can tell you in the telcom business, you know, the ability of the big guys to take over the innovative guys and a way to stifle innovation, to continue to control the market, to not have as competitive of a landscape, I think does damage to our economy. And I would just be curious—we have talked a lot about the capital part, but more on the macro standpoint here of, you know, having companies only having kind of an M&A exit strategy, whether any of you agree that that also has a negative effect on overall innovation growth in our economy. Mr. Rowe?

Mr. ROWE. Yes, just very briefly, and in my experience sitting on boards in the venture capital context, we see—and I will not name names, but over and over again the companies that are acquired very frequently end up dying. The buying company may pay a high price, but they do not really have the spirit or the passion that the entrepreneur had. The entrepreneur cashes out and leaves. And I do not know. Maybe there is some research on this. I would love to see it. But I see this in practice all the time. And if these companies can instead go public and that entrepreneur becomes the next Bill Gates running that company for another decade or two, that is where you see real impact on this country.

You know, Harvard Business School's Bill Sahlman said this nicely yesterday at a forum on crowdfunding. He said, you know, we should distinguish between fraud, which is illegal and we should clamp down on that and make sure it does not happen and enforce it, and failure. He said failure has been the thing that has made this country great. The fact that we are willing to take risks, the fact that we are willing to start companies and try to be Apple, try to be Microsoft, try to be Zynga or Facebook, that is what is great about this country, and if we try to legislate out failure, we are making a great mistake.

Mr. WADDILL. I can tell you that my last company, we did sell the company. It was a great transaction. It was great for investors. The company got sold to Amgen, another U.S.-based company, and the result of that was people were rewarded, but the employees that were there that were incented to get to the point where they

could sell the company are starting another company and continue on in the same vein.

So certainly out in the Bay Area, once you get the bug, you just keep on doing it. It is an avenue for exit, and there is some chance that the technology is going to go away. But the incentives are in place in the capitalist society to perpetuate this.

Senator WARNER. Although one of the things by having a broader-based IPO market, you know, my hope would be we would have this innovation not just taking place in the valley or Northern Virginia, but around——

Mr. WADDILL. Sure.

Senator WARNER. And I think, again, some of the opportunities. We have got to get this balance right on crowdfunding and crowdsourcing. You know, that does open up enormous, enormous opportunities elsewhere.

I will just simply close, and I want to again thank the panel for their good work and good comments. This is an area where a group of us on this Committee and others are looking at combining a series of these bills and launching a bipartisan effort. It would be, I think, great for startup companies, but it would also be great in terms of sending a message that there are actually issues that Democrats and Republicans can work together on, get done, and end up jump-starting greater job growth in our economy.

Again, my thanks to the panel, and with that the hearing is adjourned.

[Whereupon, at 11:53 a.m., the Committee was adjourned.]

[Prepared statements, responses to written questions and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

Today we will have our second full Committee hearing on "Spurring Job Growth through Capital Formation While Protecting Investors." It is our fourth hearing overall on capital formation, following Senators Reed and Crapo's Securities Subcommittee hearing on "Examining Investor Risks in Capital Raising" and Senators Tester and Vitter's Economic Policy Subcommittee hearing on, "Access to Capital: Fostering Job Creation and Innovation Through High Growth Startups."

Growing small businesses is critical to building a stronger American economy, and today we meet to consider how to help small business and entrepreneurs access the capital they need through stock markets. The intent is to help them grow and create new jobs, while having suitable protections so investors are assured they will not be taken advantage of if they put their money at risk.

Businesses may attempt to raise more capital if the process of selling stock is made easier and less costly. At the same time, investors are more likely to buy stock when they have adequate reliable information and fair trading markets. Last week in the Committee, in response to my question, Fed Chairman Bernanke said, "Start-up companies—companies under 5-years old—create a very substantial part of jobs added to the economy" and he encouraged assisting startups. SEC Chairman Schapiro has said, "companies seeking access to capital should not be overburdened by unnecessary or superfluous regulations At the same time, . . . we must balance that responsibility with our obligation to protect investors and our markets."

In previous hearings, witnesses have discussed how public markets allocate capital and help create jobs, SEC requirements for a company to go public, why some firms prefer to remain private, how investors may be solicited to buy stock, how institutional investors decide whether to buy a company's IPO shares, the importance of liquidity in the secondary markets, the importance of investor protections, measures to reduce the cost of selling stock and their potential impact on the cost of capital and other considerations.

Today, we will hear testimony from experts analyzing the history and state of the IPO market, the needs of startup and small businesses, why investors buy IPOs, the role of accounting and other disclosures, analyst conflicts of interest and other matters.

Members of this Committee on both sides of the aisle including Senators Schumer, Crapo, Tester, Reed, Vitter, Merkley, Toomey, Bennet and Johanns have been working hard on bipartisan proposals and I welcome our witness to provide their insights on these measures and others on the topic.

I look forward to working with the entire Committee and with Senate Leadership to quickly move bipartisan legislation forward.

PREPARED STATEMENT OF WILLIAM D. WADDILL

SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER,
ONCOMED PHARMACEUTICALS, INC., ON BEHALF OF
THE BIOTECHNOLOGY INDUSTRY ORGANIZATION

MARCH 6, 2012

Executive Summary

- The Biotechnology Industry Organization (BIO) represents more than 1,100 innovative biotechnology companies, along with academic institutions, State biotechnology centers, and related organizations in all 50 States.
- It can take over a decade and more than $1 billion to develop a single biotechnology therapy. Venture capital fundraising is stagnant and the IPO market is largely closed, forcing innovative companies to delay research on promising scientific breakthroughs.
- *BIO supports S. 1933, the Reopening American Capital Markets to Emerging Growth Companies Act,* which would create an "on-ramp" to the public market for "emerging growth companies." Most newly public biotech companies have no product revenue, so the 5-year transition period into compliance with Sarbanes-Oxley (SOX) Section 404(b) and certain accounting and disclosure requirements would allow growing biotechs to focus on the search for cures and treatments rather than costly regulations.
- *BIO supports S. 1544, the Small Company Capital Formation Act,* which would reform SEC Regulation A by expanding its eligibility requirements to include companies conducting direct public offerings of up to $50 million, an increase from the current threshold of $5 million. This increase would provide a valuable funding alternative for small biotech startups, giving them access to the market

at an earlier stage in their growth cycle and allowing them to raise valuable innovation capital.

- *BIO supports S. 1824, the Private Company Flexibility and Growth Act,* which would increase the limit that requires private companies to register with the SEC from 500 to 2,000 shareholders, giving growing biotech companies more investor options to finance their early stage research. The bill would also exempt employees from the shareholder count, allowing biotech companies to attract and hire the most qualified researchers and scientists.
- *BIO supports S. 1831, the Access to Capital for Job Creators Act,* which would require the SEC to revise Rule 506 of Regulation D to permit general solicitation in direct public offerings, broadening the investor base.

* * * * *

Good morning Chairman Johnson, Ranking Member Shelby, Members of the Committee, ladies, and gentlemen. My name is William Waddill, and I am the Senior Vice President and Chief Financial Officer of OncoMed Pharmaceuticals in Redwood City, California. I am also the Co-chairman of the Finance and Tax Committee at the Biotechnology Industry Organization (BIO). I want to thank you for the opportunity to speak with you today about the unique hurdles that innovative biotechnology companies face as they work toward developing cures and breakthrough medicines to treat crippling illnesses that affect families across the Nation.

Biotechnology has incredible potential to unlock the secrets to curing devastating disease and helping people to live longer, healthier, and more productive lives. My company, OncoMed Pharmaceuticals, is working at the cutting edge of oncology research, focusing on a specific set of cells within tumors that drives the growth of the tumor and can morph into various cell types within the tumor. We have developed the ability to isolate and monitor these tumor initiating cells, and our studies have shown that they are more resistant to standard chemotherapy agents. Some current treatments may succeed at initially decreasing the size of a cancer, but leave behind an increased proportion of these most malignant cells. We have developed a portfolio of antibodies that target biologic pathways critical for survival of tumor initiating cells, with the goal being to stop those cells from replicating. We believe these models are more representative of the effects of these treatments in cancer patients than traditional models using cancer cell lines, which may no longer accurately reflect the properties of the original tumor. Currently we have three antibodies that target tumor initiating cells in Phase I and are developing other promising therapeutic candidates.

BIO represents more than 1,100 innovative companies like mine, along with academic institutions, State biotechnology centers, and related organizations in all 50 States. Entrepreneurs across the biotech industry are conducting groundbreaking science like ours, and are deeply invested in treating the severe illnesses that families around the Nation and world face. At the same time, biotech leaders must deal with the day-to-day challenges of running a small business. Of great import in the biotechnology industry is the constant struggle to find working capital. It takes 8 to 12 years for a breakthrough company to bring a new medicine from discovery through Phase I, Phase II, and Phase III clinical trials and on to FDA approval of a product. The entire endeavor costs between $800 million and $1.2 billion. For the majority of biotechnology companies that are without any product revenue, the significant capital requirements necessitate fundraising through any source available, particularly venture capital firms. Later, we must turn to the public markets in the final stages of research to fund large-scale and expensive clinical trials.

Startup companies depend on venture capital fundraising to finance the early stages of research and development. In fact, many companies, including mine, rely on venture financing to fund even middle- and late-stage clinical trials. However, the current venture landscape has made this type of funding difficult. In 2011, we saw only 98 first round venture deals with biotechnology companies, a significant drop from the industry's peak of 141 in 2007. Last year was only the third time since 2000 that the number of deals dropped below 100. Small, startup companies are the innovative heart of our industry, but depressed financing means that potential cures and treatments are often left on the laboratory shelf.

Further, venture capitalists expect this downward trend to continue. A recent survey conducted by the National Venture Capital Association (NVCA) found that 41 percent of venture capital firms have decreased their investments in the biopharmaceutical sector in the past 3 years. Additionally, 40 percent of venture capitalists reported that they expect to further decrease biopharmaceutical investments over the next 3 years. Therapeutic areas that affect millions of Americans will be hit by this change in investment strategy, including cardiovascular disease, diabetes, and cancer.

A significant reason for reluctance in venture investing has been the inaccessibility of the public markets. Venture capital investors need to know that they will have an exit through which they can get a return on their investment; often, they look for this exit when a company enters the public market. Unfortunately, due to the current economic climate, it is becoming harder for biotech companies to go public. As a result, venture capital firms are turning elsewhere to make their investments, leading to a dearth of innovation capital for biotechnology.

Despite the desire on the part of companies and private investors for a clear path to a public offering, public markets remain essentially closed to growing biotech companies. There was only $1 billion in public financing for biotechnology last year, just a third of the total from 2007. Though funding totals are slowly climbing back toward pre-recession levels, this progress has been made almost entirely by larger, more mature companies. These more established companies are getting better deals and emerging companies making their first forays onto the public market are getting squeezed out. The weak demand for public offerings for smaller companies is restricting access to capital. This then hampers critical research, forces companies to stay private for longer, and depresses valuations of later-stage venture rounds. Although the industry is slowly recovering from its recession-induced nadir (in 2008 there was only one biotechnology IPO), this progress is not fast enough for struggling biotechs that need funding to innovate or patients waiting for breakthrough medicines.

These disturbing investment trends could be ameliorated by allowing emerging growth companies increased access to the public markets. In a recent survey conducted by NASDAQ and the NVCA, 86 percent of chief executive officers cited "accounting and compliance costs" and 80 percent cited "regulatory risks" as key concerns about going public. If burdens on public financing were removed, private investors would have greater certainty that they would have an avenue to exit, leading to augmented venture capital investment, the lifeblood of the biotechnology industry. Additionally, companies on the cusp of a public offering would have the confidence that a successful IPO could fund their late-stage trials and push therapies to patients who desperately need them.

Public Market On-Ramp

Senators Schumer and Toomey have introduced S. 1933, the Reopening American Capital Markets to Emerging Growth Companies Act. This bill would create a new category of issuers, called "emerging growth companies," and ease their transition onto the public market. The legislation would give newly public companies much-needed relief by allowing them to transition into full regulatory compliance over time as they grow. This transitional "on-ramp" will encourage biotechnology companies and other small businesses on the cusp of going public to venture onto the public market.

One of the key components of the on-ramp is the 5-year transition period before emerging growth companies are subject to full Sarbanes-Oxley (SOX) Section 404(b) compliance. While we can all agree that investors benefit from greater transparency, the unintended consequence of the regulations found in Section 404(b) is the diversion of precious invested capital away from innovative product development and job growth to onerous, costly compliance with little to no benefit to investors or the general public. The opportunity cost of this compliance can prove damaging, resulting in delays to developing cures and treatments during a necessary and often prolonged search for investment capital.

SEC studies have shown that SOX compliance can cost companies more than $2 million per year. The biotechnology sector is especially disadvantaged by this burden due to the unique nature of our industry. Newly public biotech companies have little to no product revenue, so they are essentially asking investors to pay for SOX reporting rather than research and development. The compliance costs are fixed and ongoing, and have a severe impact on the long-term investing of microcap and small cap companies at the forefront of developing new treatments for severe diseases. Companies are the most vulnerable during their first few years on the public market, yet they are forced to shift funds from core research functions to compliance costs. This can lead to research programs being shelved or slowed as compliance takes precedence.

Further, the true value of biotech companies is found in scientific milestones and clinical trial advancement toward FDA approvals rather than financial disclosures of losses incurred during protracted development terms. Investors often make decisions based on these development milestones rather than the financial statements mandated by Section 404(b). Thus, the financial statements required do not provide much insight for potential investors, meaning that the high costs of compliance far outweigh its benefits.

In 2010, Congress made the important acknowledgement that SOX Section 404(b) is not an appropriate requirement for many small reporting companies. The Dodd-Frank Wall Street Reform and Consumer Protection Act sets a permanent exemption from Section 404(b) for companies with a public float below $75 million. Additionally, the SEC Small Business Advisory Board in 2006 recommended that the permanent exemption be extended to companies with public floats of less than $700 million.

Similarly, the Reopening American Capital Markets to Emerging Growth Companies Act would allow emerging growth companies time to find their footing on the public market without diverting precious funds to onerous SOX reporting. I support giving these companies 5 years to transition onto the public market, providing them with time to create jobs and continue research before entering full regulatory compliance.

Additionally, an on-ramp transition period would allow emerging growth companies to provide only 2 years of previous audited financial statements prior to going public rather than the 3 years currently required. Similar to the transition into SOX compliance, this change would save emerging biotech companies valuable innovation capital that could be used for important research and development. I fully appreciate and agree that strong auditing standards can enhance investor protection and confidence and I support this goal. However, overly burdensome auditing standards impose a significant cost burden on emerging growth companies without providing much pertinent information to their investors. By allowing for limits on the look-back requirements for audited financial statements, a public market on-ramp would balance the goals of cost-efficient auditing standards and investor protection. Two years of audited financials is sufficient for investors to gather information about companies going public. Further, most biotech investors look to scientific and development information when making investment decisions, so the extra year of audited financials imposes costs without providing benefit. Requiring just 2 years of audited financial statements would continue to protect investors but would allow emerging growth companies to expend more of their capital on the search for breakthrough medicines.

An on-ramp approach would also exempt emerging growth companies from certain rules issued by the Public Company Accounting Oversight Board (PCAOB), particularly a proposal being considered regarding mandatory audit firm rotation.

Audit fees would most certainly increase with the implementation of audit firm rotation. There would be a steep learning curve for any new audit firm, and the additional resources necessary to educate the audit firm about business and operations would raise audit fees. Companies might even need to hire more compliance personnel to avoid disruption of day-to-day operations, further increasing the cost burden. Audit firms have also suggested that audit firm rotation could increase the challenges and costs to maintain high-quality personnel. The cost associated with these scenarios would be transferred to the company while making relationships between the audit firm and the company more difficult to establish. Each new cost burden would require funds to be diverted from research and development to the transition between audit firms, slowing the progress of cures and treatments for which patients are waiting.

I support the ongoing efforts to incentivize emerging growth companies to go public and make their transition smoother while continuing to protect investors. Easier access to the public market will improve the health and stability of the biotechnology industry, both for companies considering an IPO and for those which are still seeking private investment.

Financial Services Capital Formation Proposals

While easing entry onto the public market is a key component of capital formation for growing companies, there are several proposals being considered that would benefit companies that are not yet suited to enter the public markets but face their own unique burdens as they grow. These proposals would strengthen the fundraising potential for small, innovative biotech companies developing solutions to the health problems that our Nation faces.

SEC Regulation A (Direct Public Offerings)

Regulation A, adopted by the SEC pursuant to Section 3(b) of the Securities Act of 1933, was created to provide smaller companies with a mechanism for capital formation with streamlined offering and disclosure requirements. Updating it to match today's market conditions could provide an important funding source for small private biotechnology companies.

Regulation A allows companies to conduct a direct public offering valued at less than $5 million while not burdening them with the disclosure requirements tradi-

tionally associated with public offerings. The intent of Regulation A was to give companies which would benefit from a $5 million influx (*i.e.,* small companies in need of capital formation) an opportunity to access the public markets without weighing them down through onerous reporting requirements.

However, the $5 million offering amount has not been adjusted to fit the realities of the costs of development and Regulation A is not used by small companies today. The current threshold was set in 1992 and is not indexed to inflation, pushing Regulation A into virtual obsolescence. As it stands, a direct public offering of just $5 million does not allow for a large enough capital influx for companies to justify the time and expense necessary to satisfy even the relaxed offering and disclosure requirements.

Senators Tester and Toomey have introduced a Regulation A reform bill, the Small Company Capital Formation Act (S. 1544), which I believe would have a positive impact for small biotechnology companies. The legislation increases the Regulation A eligibility threshold from $5 million to $50 million while maintaining the same disclosure requirements. This increase would allow companies to raise more capital from their direct public offering while still restricting the relaxed disclosure requirements to small, emerging companies. The Small Company Capital Formation Act could provide a valuable funding alternative for small biotech startups, giving them access to the public markets at an earlier stage in their growth cycle and allowing them to raise valuable innovation capital. I support this legislation.

SEC Reporting Standard (Shareholder Limit)

Although the SEC generally monitors public companies, the agency also keeps tabs on private companies when they reach a certain size. Modifying the SEC's public reporting standard would prevent small private biotechnology companies from being unnecessarily burdened by shareholder regulations.

Once a private company has 500 shareholders, it must begin to disclose its financial statements publicly. Biotechnology companies are particularly affected by this 500 shareholder rule due to our industry's growth cycle trends and compensation practices. As I have mentioned, the IPO market is essentially closed to biotechnology, leading many companies to choose to remain private for at least 10 years before going onto the public market. This long timeframe can easily result in a company having more than 500 current and former employees, most of whom have received stock options as part of their compensation package. Under the SEC's shareholder limit, a company with over 500 former employees holding stock, even if it had relatively few current employees, would trigger the public reporting requirements. Exempting employees from any shareholder limit is a minimum necessary measure to ensure growing biotech companies are able to hire the best available employees and compensate them with equity interests, allowing them to realize the financial upside of a company's success.

Senators Carper and Toomey have introduced legislation, the Private Company Flexibility and Growth Act (S. 1824), which would address these barriers to private company growth. Their bill would increase the shareholder limit from 500 to 2000, relieving small biotech companies from unnecessary costs and burdens as they continue to grow. As it stands, the 500-person limit encumbers capital formation by forcing companies to focus their investor base on large institutional investors at the expense of smaller ones that have been the backbone of our industry. The legislation would also exempt employees from the shareholder count, allowing growing biotech companies to attract and hire the most qualified researchers and scientists. I support the Private Company Flexibility and Growth Act, as it would remove significant financing burdens from small, growing companies.

SEC Regulation D (Ban on General Solicitation)

Another potential avenue for capital formation in the biotech industry is SEC Regulation D. Under Rule 506 of Regulation D, companies can conduct offerings to accredited investors without complying with stringent SEC registration standards. This exemption allows companies to access sophisticated investors (who do not need as much SEC protection) without burdensome disclosure requirements. However, the upside of this fundraising avenue is hindered by the ban on general solicitation in Rule 506. Companies are limited in their investor base by this rule, meaning that a vast pool of investors remains untapped. If the ban on general solicitation were lifted, growing biotech companies would be able to access funds from the entire range of wealthy SEC accredited investors without undergoing the full SEC registration process.

I support Senator Thune's Access to Capital for Job Creators Act (S. 1831), which would require the SEC to revise Rule 506 and permit general solicitation in offer-

ings under Regulation D. If enacted, this legislation would enhance fundraising options for growing biotech companies searching for innovative cures and treatments.

Closing Remarks

The U.S. biotechnology industry remains committed to developing a healthier American economy, creating high-quality jobs in every State, and improving the lives of all Americans. Additionally, the medical breakthroughs happening in labs across the country could unlock the secrets to curing the devastating diseases that affect all of our families. There are many pitfalls and obstacles endemic to this effort, including scientific uncertainty and the high costs of conducting research. However, the regulatory burdens I have discussed continue to stand in our way without providing any real benefit to the investors the laws purports to protect. By making targeted changes that support emerging growth companies in the biotechnology industry and elsewhere, Congress can unburden these innovators and job creators while maintaining important investor protections. Congress has the opportunity inspire biotechnology breakthroughs and allow innovators and entrepreneurs to continue working toward delivering the next generation of medical breakthroughs—and, one day, cures—to patients who need them.

PREPARED STATEMENT OF JAY R. RITTER

CORDELL PROFESSOR OF FINANCE
WARRINGTON COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF FLORIDA

MARCH 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I want to thank you for inviting me to testify. My name is Jay R. Ritter, and I am the Cordell Professor of Finance at the University of Florida's Warrington College of Business Administration. I have been studying the initial public offering (IPO) market for over three decades, and I have published dozens of peer-reviewed articles on the topic. I have consulted with private companies, Government organizations, and law firms on IPO-related matters.

I will first give some general remarks on the reasons for the low level of U.S. IPO volume this decade and the implications for job creation and economic growth, and then make some suggestions on the specific bills that the Senate is considering.

First, there is no doubt that fewer American companies have been going public since the tech stock bubble burst in 2000, and the drop is particularly pronounced for small companies. During 1980–2000, an average of 165 companies with less than $50 million in inflation-adjusted annual sales went public each year, but in 2001–2011, the average has fallen by more than 80 percent, to only 29 small firm IPOs per year. The patterns are illustrated in Figure 1.

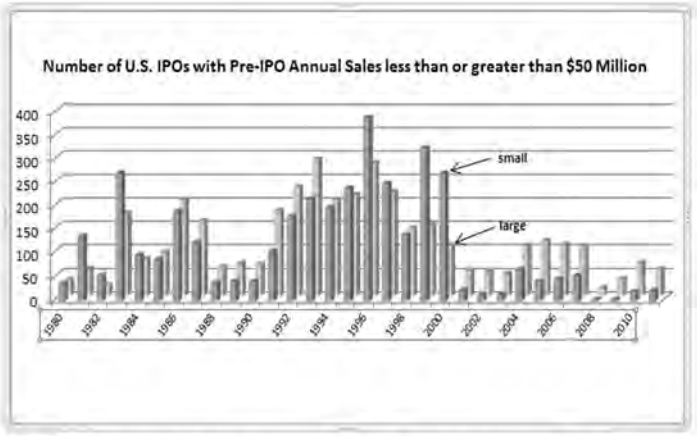

Figure 1: The number of U.S. IPOs by year, 1980-2011, with pre-IPO last twelve months sales less than (small firms) or greater than (large firms) $50 million (2009 purchasing power). Source: Gao, Ritter, and Zhu "Where have All the IPOs Gone?"

Although there is no disagreement about the existence of this prolonged drought in small company IPOs, there is disagreement about a) the causes of the decline in IPOs, b) the implications for the economy, and c) what should be done, if anything, to rejuvenate the IPO market and spur capital formation. My opinions about the causes of the decline are at odds with the conventional wisdom. My opinions about the implications for the economy are not too different from those of some, such as Prof. John Coates of Harvard Law School, who testified before this Committee on December 14, 2011. These opinions are different, however, from those of the IPO Task Force, whose chair, Kate Mitchell, also testified on December 14, and those of the *Wall Street Journal*'s editorial writers. My opinions about what should be done are similar to those of several witnesses, but in disagreement with those of several others who have a much different opinion about the causes and implications than I do.

The Causes of the Decline in IPO Volume

The conventional wisdom is that a combination of factors, including a drop in public market valuations of tech companies, heavy-handed regulation such as Sarbanes-Oxley (SOX), and a drop in analyst coverage of small companies, have discouraged companies, especially small companies, from going public in the United States in the past decade. I agree with the conventional wisdom that these factors have discouraged small companies from going public, but I believe that only a small part of the drop in small company IPO volume can be explained by these factors. Instead, I think that the more fundamental problem is the declining profitability of small firms. In many industries, over time it has become more important for a firm to be big if it is to be profitable. Emerging growth companies (EGCs) are responding to this change in the merits of being a small, stand-alone firm by merging in order to grow big fast, rather than remaining as an independent firm and depending on organic (internal) growth.

Numerous facts support the idea that small companies are not going public because being small is not best, whether private or public. These facts are documented in "Where Have All the IPOs Gone?", coauthored with Xiaohui Gao and Zhongyan Zhu.[1] My co-authors and I document that U.S. public market investors have earned low returns in the 3 years after the IPO on the IPOs of small companies, defined as firms with less than $50 million in pre-IPO annual sales (2009 purchasing power), in every decade for at least 30 years. Furthermore, we show that for both recent IPOs and for public companies that have been traded for at least 3 years, the fraction of small companies with positive earnings has been on a long-term downtrend, starting far before the tech stock bubble burst in 2000. Other studies have documented that a larger and larger fraction of aggregate corporate earnings are being earned by the largest firms, and that the fraction of public firms that earn positive profits in a year has been on a long-term decline.[2]

In the last decade, a larger fraction of venture capital-backed firms have sold out in trade sales rather than go public, as documented by Kate Mitchell in her December 14, 2011 testimony to this Committee. The IPO Task Force interprets this evidence as suggesting that the IPO market is broken. My coauthors and I show that, of the small companies that do go public, there has been an increase over time in the fraction that is subsequently acquired, and as well as the fraction that subsequently make acquisitions. This "eat or be eaten" evidence is consistent with the notion that getting big fast has become more important over time, and does not imply that the IPO market is broken.

My co-authors and I also show that in the last decade there has been no deterioration in analyst coverage for companies that do go public, inconsistent with the assertion that a lack of analyst coverage is deterring IPOs.

My co-authors and I address whether the low profitability of small publicly traded firms in the last decade can be attributed to the costs of compliance with SOX's Section 404. To ascertain whether this is important or not, we add back to earnings an estimate, provided by the U.S. SEC, of the SOX costs incurred by small firms. We report that the downtrend in profitability would be present even if these costs did not exist. Furthermore, as Prof. John Coates mentioned in his December 14th testimony, there has been no resurgence of small company IPOs after the SEC altered the regulations to lessen these costs.

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[1] See "Where Have All the IPOs Gone?" Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu, March 2012, unpublished University of Florida working paper. Many additional tables can be found on the "IPO Data" page of my Web site (just Google "Jay Ritter").

[2] See DeAngelo, Harry, Linda DeAngelo, and Douglas Skinner, 2004, "Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings," *Journal of Financial Economics,* 72, 425–456; and Fama, Eugene F., and Kenneth French R., 2004, "New Lists: Fundamentals and Survival Rates," *Journal of Financial Economics,* 73, 229–269.

If the U.S. IPO market is broken for small companies, but being a small independent firm is still attractive, we might expect to see many small U.S. firms going public abroad. In fact, as documented by several studies, only a few U.S. firms per year have gone public abroad in recent years.[3] In "Europe's Second Markets for Small Companies," my co-authors and I document that European public market investors have earned low returns on European IPOs from 1995–2009 that listed on Europe's markets that cater to emerging growth companies.[4] Furthermore, we document that 95 percent of the listings on London's Alternative Investment Market (AIM) have been "placings," restricted to qualified institutional buyers (QIBs). Most of these IPOs have been for very small amounts, and no liquid market ever developed. The reality is that very few of the AIM IPOs would have qualified for Nasdaq listing.

In addition, if being small but public was unattractive relative to being small but private, we might see many U.S. publicly traded small companies going private. Instead, the vast majority of small companies that have voluntarily delisted have done so by selling out to a larger company, rather than by staying independent and going private.[5]

To summarize, there is a large body of facts supporting the view that the drop in small company IPO activity is due to the lack of profitability of small stand-alone businesses relative to their value as part of a larger organization. In my opinion, this is the major reason why venture capital-backed firms are selling out (merging) rather than going public. This is a large firm vs small firm choice, not a private firm vs. public firm choice. Although the IPO market may need reforms, private firms are not avoiding IPOs because the IPO market is broken, but because being part of a larger organization creates more value.

Implications for the Economy of the Decline in IPO Volume

In "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996–December 2010," my co-authors and I document the employment and revenue growth for U.S. companies that went public from June 1996–December 2010.[6] For the 2,766 domestic operating company IPOs from this period, we find that the average company added 822 employees since their IPO. In the 10 years after going public, the average company increased employment by 60 percent, amounting to a 4.8 percent compound annual growth rate (CAGR).[7]

One can use these numbers to calculate the number of jobs that would have been created if the average annual volume of domestic operating company IPOs from 1980–2000 had continued during 2001–2011, rather than collapsing. In 1980–2000, an average of 298 domestic operating companies per year went public, whereas an average of only 90 domestic operating companies per year have gone public since then, a difference of 208 IPOs per year. Over the eleven year period 2001–2011, this amounts to a shortfall of 2,288 IPOs, with 822 jobs per IPO lost. Multiplying these two numbers together results in a figure of 1.88 million jobs that were not "created" due to the IPO shortfall. This calculation assumes that these employees would have been sitting at home watching TV if they weren't hired by the recent IPO firm, and that the roughly $100 million raised per IPO would not have been invested in anything else. But, in a mechanical sense, 1.88 million jobs have been "lost."

This 1.88 million figure is dramatically lower than the 10 million jobs figure that Delaware Governor Jack Markell used in his March 1, 2011 *WSJ* opinion piece "Restarting the U.S. Capital Machine," or the 22.7 million figure used in the IPO Task Force report presented to the U.S. Treasury and this Committee in late 2011 by task force chairwomen Kate Mitchell. The 22.7 million number comes from a 2009 Grant Thornton white paper, "A Wake-up Call for America," written by David Weild and Edward Kim. Weild and Kim make four different assumptions than my co-authors and I do in order to generate their 22.7 million jobs lost figure.

First, Weild and Kim make the reasonable assumption that IPO volume should be proportional to real GDP, and since the U.S. economy has grown over the last 30 years, one would expect IPO activity to rise rather than be flat. Thus, our num-

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[3]Doidge, Craig, G. Andrew Karolyi, and Reńe M. Stulz, 2009, "Has New York Become Less Competitive than London in Global Markets? Evaluating Foreign Listing Choices over Time," *Journal of Financial Economics* 91, 253–277.

[4]See "Europe's Second Markets for Small Companies," by Silvio Vismara, Stefano Paleari, and Jay R. Ritter, *European Financial Management,* forthcoming.

[5]See Table 8 of Gao, Ritter, and Zhu (2012).

[6]Martin Kenney, Donald Patton, and Jay R. Ritter, work in progress for the Kauffman Foundation on "Post-IPO Employment and Revenue Growth for U.S. IPOs, June 1996–December 2010."

[7]The 60 percent cumulative average growth in employment and 4.8 percent CAGR numbers are based on the 1,857 IPOs from June 1996–December 2000.

ber, which assumes that IPO activity would be constant over time, is biased downwards.

Second, on page 26 Weild and Kim make the assumption that the normal level of IPO activity is that of 1996, the peak of the IPO market, and that the volume should grow from this level. This assumption, that the 1996 number of 803 IPOs is normal, biases their number upwards. Third, they assume that each IPO that didn't occur would have had 1,372 employees before going public, and post-IPO employment grows at a CAGR of 17.8 percent, a number that implies employment growing by 415 percent in the 10 years after an IPO. The 17.8 percent per year number is justified based on a "select" group of prior IPOs. In other words, they assume that thousands of companies that didn't go public would have grown as fast as companies such as Google if they had! This assumption, which I would tend to categorize as completely ridiculous, has a huge impact on their calculations. Fourth, they assume that there was an IPO shortfall starting in 1997, rather than 2001, and that more than 1,500 additional firms would have gone public in 1997–2000 and then grown their employment by 17.8 percent per year for more than a decade. This 1997–2000 shortfall assumption, combined with the 17.8 percent CAGR assumption, adds at least 9 million lost jobs to their 22.7 million total.

What Should Be Done

If the reason that many small companies are not going public is because they will be more profitable as part of a larger organization, then policies designed to encourage companies to remain small and independent have the potential to harm the economy, rather than boost it. Not all EGCs should stay private or merge, however, and to the degree that excessive burdens associated with going public, and being public, result in less capital being raised and wisely invested, standards of living are lowered. I do not think that the bills being considered will result in a flood of companies going public. I do not think that these bills will result in noticeably higher economic growth and job creation.

In thinking about the bills, one should keep in mind that the law of unintended consequences will never be repealed. It is possible that, by making it easier to raise money privately, creating some liquidity without being public, restricting the information that stockholders have access to, restricting the ability of public market shareholders to constrain managers after investors contribute capital, and driving out independent research, the net effects of these bills might be to reduce capital formation and/or the number of small EGC IPOs.

I think that Prof. John Coates zeroed in on the tradeoffs in his December 14, 2011 testimony. He stated "While the various proposals being considered have been characterized as promoting jobs and economic growth by reducing regulatory burdens and costs, it is better to understand them as changing, in similar ways, the balance that existing securities laws and regulations have struck between the transaction costs of raising capital, on the one hand, and the combined costs of fraud risk . . . "As he notes, fewer investor protections can potentially result in more fraud, with rational investors responding by demanding higher promised returns from all companies, resulting in good companies receiving a lower price for the securities that they sell. Good investor protection laws, and their timely and effective enforcement, can lower the cost of capital for good companies, but investor protection does impose compliance costs on all companies.

I will now comment on some of the specific bills under consideration by the Senate:

S. 1791 "Democratizing Access to Capital Act of 2011" and S. 1970 "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011"

These bills deal with Regulation D and its requirements on solicitations, and crowdfunding. In general, they reduce constraints on the ability of parties seeking capital to reach out to unsophisticated investors, potentially increasing the amount of fraud. Fraudsters are happy to relieve unsophisticated investors of their cash.

An increase in fraud if these bills are passed is not, however, an automatic result. When eBay and Craigslist were created, a concern was raised about whether fraud by sellers, and bounced checks from buyers, would be so prevalent that an electronic exchange that matched buyers and sellers of nonfinancial goods and services would fail. In practice, both organizations have been successful at matching buyers and sellers, even if there are some unsatisfactory outcomes.

In financial markets, as with eBay and Craigslist, it is possible that organizations will evolve that provide sufficient voluntary policing and certification to minimize the amount of fraud and create value by bringing buyers and sellers (investors and entrepreneurs) together.

I am not certain what problem crowdfunding is solving. Many startups are able to get funding from angel investors, and, once a certain threshold of size has been reached, venture capital (VC) firms have billions to invest. If VC firms were demanding excessively onerous terms, one might expect to see extremely high returns for the limited partners (LPs) of VC funds. Over the last decade, however, the bigger problem has been low returns. The market is not failing when firms with poor investment prospects are unable to get funding. The market is working when firms with good prospects are able to get funded at reasonable cost and grow, and firms with poor prospects are deprived of capital that would be wasted.

S. 1970 appears to offer some protections to investors that are not present in S. 1791. I am modestly supportive of S. 1970, but not enthusiastic about S. 1791.

S. 1824 "The Private Company Flexibility and Growth Act"

This bill increases the 12(g)(1) of the 1934 Act threshold at which public reporting of financial statements is required from 500 to 2,000 shareholders of record, and Section 3 removes current and past employees from the count. The number of beneficial shareholders, of course, may be far in excess of the number of shareholders of record since individuals normally hold shares in street name.

On December 1, 2011, Prof. John Coffee of Columbia Law School testified that the shareholders of record requirement should be supplemented with a public float requirement: if either the 2,000 shareholders of record threshold is passed, or if the public float is above $500 million, public reporting should be required.

My suggestion would be to keep the 500 shareholders of record threshold, but exclude current and former employees from the count, and to add a public float requirement. Alternatively, the "shareholders of record" requirement should be changed to reflect the fact that for publicly traded firms, individuals keep their shares in street name.

S. 1933 "Reopening American Capital Markets to Emerging Growth Companies Act of 2011"

This bill establishes a new category of issuers, called emerging growth companies (EGCs) that have less than $1 billion in annual revenue at the time of SEC registration, and exempts them from certain disclosure requirements, such as executive compensation. The exemptions would end either 5 years after the IPO or when the annual revenue exceeds $1 billion.

From 1980–2011, 7,612 operating companies went public in the United States, excluding banks and S&Ls and IPOs involving units, an offer price below $5.00, or partnerships. Ninety-four (94) percent of these companies had annual sales of below $1 billion when they went public, including Carnival Cruise Lines and AMF Bowling.

Section 3 deals with disclosure obligations. I cannot think of any reason for why public market investors should not need to know how much executives are paying themselves, nor have a say on this cost through shareholder voting.

Section 6 deals with coverage from sell-side research analysts. As I interpret it, this legislation would abolish quiet period restrictions on the ability of sell-side analysts that work for an underwriter to provide research to institutional investors for EGCs, which historically have comprised 94 percent of all IPOs. Because the sell-side analysts are potentially privy to inside information, they will be at an informational advantage relative to other analysts. This proposed legislation is completely at odds with the logic of Reg FD, which seeks to create a level playing field. The proposal may have the effect of crowding out unbiased independent research.

As I mentioned earlier in this testimony, my research shows that there has been no lack of analyst coverage of companies conducting IPOs in the last decade.[8] If the purpose of Section 6 is to create incentives for analyst coverage because none exists, this legislation is based on a faulty premise.

PREPARED STATEMENT OF KATHLEEN SHELTON SMITH

CO-FOUNDER AND CHAIRMAN, RENAISSANCE CAPITAL, LLC

MARCH 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee:

I want to thank you for inviting me to testify today. Capital formation, when accomplished through a transparent IPO market open to all investors, plays an impor-

[8] Table 6 of Gao, Ritter, and Zhu (2012) shows that essentially all IPOs with a midpoint of the file price range of above $8 receive coverage. This $8 cutoff is a good proxy for IPOs that are large enough to attract institutional investors.

tant role in allocating capital to our best entrepreneurial companies, spurring significant and sustainable job growth. We are all concerned about economic growth and job creation, so it is no surprise that our eyes would turn to the IPO market—America's most admired system for funding entrepreneurs.

The issue we address today is access to capital by entrepreneurial companies. When America's job-creating smaller companies are unable to access the IPO market, we need to understand why and what we can do about it. Measures to ease costly regulatory burdens that weigh most heavily on small firms may be helpful. At the same time, care must be taken in waiving certain disclosure and stock promotion rules that could result in misallocating capital to weak or fraudulent companies. Weak companies that ultimately fail cause job losses, not job creation, and result in serious stock market losses to investors who abandon the IPO market, as was the case after the Internet bubble burst.

Renaissance Capital's IPO Expertise

We share the concerns of lawmakers about the IPO market and are honored to be asked for our thoughts on this important policymaking process. For over 20 years, Renaissance Capital has had a singular focus on the IPO market. We are involved in IPOs in three ways:

1. We are an independent research firm. We provide institutional investors with research on IPOs. We analyze every IPO in the United States and we cover the international IPO market.
2. We are an indexing firm. We create and license IPO indexes that measure the investment returns of newly public companies. These indices are used by IPO investors as a benchmark of performance.
3. We are an IPO investor. We invest in newly public companies through a mutual fund and separately managed institutional accounts.

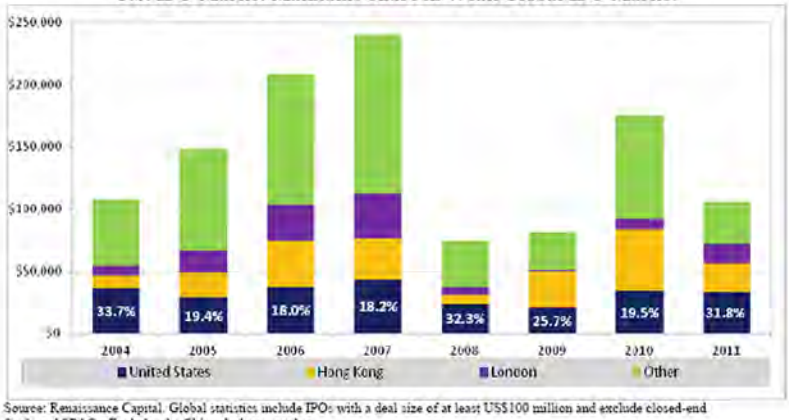
Regulators around the world often reach out to us about our views on IPO issuance, valuation and research. These regulators are studying the best practices of the U.S. IPO market. They know that a well-functioning IPO market can be the most efficient way for them to allocate capital to their growing enterprises. A well-functioning IPO market is based upon full and honest disclosure of company information made available evenly to all public investors.

I will start by examining the condition of our IPO market, including where we stand in global IPO market share, what is working and what is not, and the importance of investor returns in the equation. I will then make suggestions on the specific bills under consideration.

The U.S. IPO Market is Doing Well Relative to IPO Markets Around the World

While there is legitimate concern that recent issuance in the U.S. IPO market has been below long-term trends, the U.S. market is not alone. IPO markets globally have been hurt by the 2008 U.S. financial crisis and the 2011 European Sovereign debt crisis. However, in the context of weak global IPO markets, the United States has actually gained market share, accounting for 32 percent of global IPO proceeds in 2008 and again in 2011. In 2011, when international IPO issuance fell 50 percent, U.S. IPO issuance fell only 6 percent. This tells us that when put to the test of a financial crisis, investors trust the disclosure, transparency and depth of the U.S. IPO market more than any other IPO market in the world. So, despite the low IPO issuance levels, much of the U.S. IPO market is functioning as well as can be expected under challenging conditions.

U.S. IPO Market Maintains Share in Weak Global IPO Market

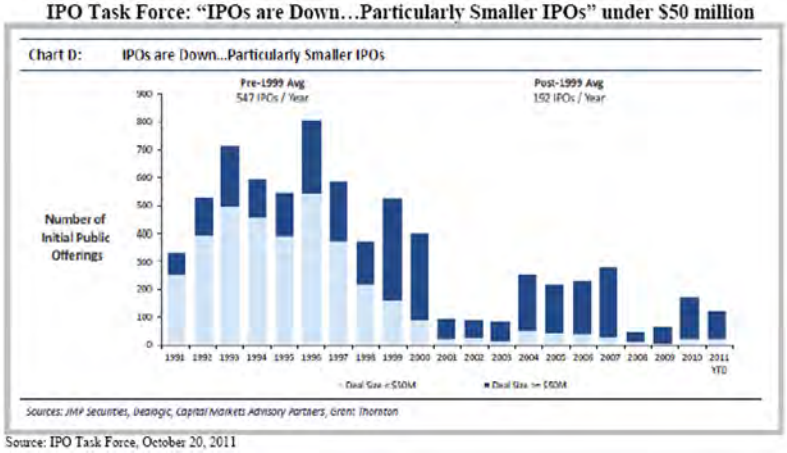


Source: Renaissance Capital. Global statistics include IPOs with a deal size of at least US$100 million and exclude closed-end funds and SPACs. Excludes the China-A shares market.

Larger Issuers Continue to Access the IPO Market

The IPO Task Force provided helpful data about IPO issuance since 1991. This data shows that while smaller IPOs have effectively disappeared, larger companies raising over $50 million in IPO proceeds continue to access the IPO market. From 2000 to date, investors have experienced the weakest period of stock market returns in decades. As the chart shows, during this period, the larger issuers have dominated the IPO market. In weak markets, investors gravitate to the perceived safety of larger, more liquid IPOs.

IPO Task Force: "IPOs are Down…Particularly Smaller IPOs" under $50 million



Source: IPO Task Force, October 20, 2011

Furthermore, despite our current regulatory regime, we find little evidence that these larger issuers have been deterred from tapping the IPO market. Today, we count over 200 companies in the U.S. IPO pipeline seeking to raise over $52 billion in aggregate proceeds who have undergone financial audits, implemented Sarbanes-Oxley policies and filed full disclosure documents with the SEC. This is the largest backlog of companies lined up to go public that we have seen in over a decade. Over 92 percent of these companies are larger issuers seeking to raise over $50 million in IPO proceeds.

The U.S. IPO Market is Closed to Small Issuers

On the other hand, as the IPO Task Force concluded, smaller IPOs of $50 million proceeds or less have become a reduced presence in the IPO market. Prior to 1999, smaller IPOs represented 50 percent or more of the IPO market, currently they represent less than 15 percent. Helping these smaller job-creating companies lower the

cost of accessing the IPO market, while protecting investors, may help somewhat in boosting the presence of smaller IPOs in the market.

However, opening the path for easier issuance by smaller companies only works if investors are interested in buying these IPOs. Thus, it is even more critical to address the investor side of the equation. At present, the trading market for IPOs is highly volatile with average IPO trading turnover on the first day often equal to the number of shares offered. This suggests that IPO shares are being placed with short-term trading clients of the IPO Underwriters. IPO shares placed with a broader base of fundamentally oriented investors would go a long way to help open the IPO market to smaller issuers. We urge policymakers to study ways to encourage IPO Underwriters to allocate IPOs to a broader base of long-term investors.

Ultimately the IPO Market Opens Up When IPO Investors Earn Positive Returns

While policy to ease the way for more small issuers to accomplish an IPO may be helpful, the most powerful fix for the IPO market would be to improve returns for IPO investors. Unfortunately, there is little policymakers can do on this front, short of creating a Government fund that purchases shares in every small IPO—which we would not recommend. Returns to IPO investors matter because good returns for IPO investors drive future IPO activity. IPO issuance grows when returns are positive. The IPO market closes when returns are negative.

Weak IPO Returns Explain Low IPO Issuance for Smaller IPOs

Source: Renaissance Capital. Statistics include all IPOs except closed-end funds and SPACs. IPO Performance reflects average two-year aftermarket returns from 1998-2002 and returns from the FTSE Renaissance US IPO Capped Index from 2003 through February 29, 2012.

After a long run through the 1990s of positive equity returns for all investors, the bursting of the Internet bubble devastated IPO investors, causing losses of –49 percent and –61 percent in 1999 and 2000, respectively, far worse than the rest of the equity market. No wonder in the years following that disaster, investors were cautious about smaller IPOs, shutting off IPO issuance for these important job-creating small companies. Over 70 percent of the IPOs during that period were unprofitable companies whose offerings were promoted by the IPO Underwriters' research analysts. We caution lawmakers to avoid new policies that would pave the way for IPO Underwriters to engage in these types of promotional activities again.

We are encouraged that following the poor returns of 2008 and 2011, returns for IPO investors have turned strongly positive so far in 2012. These positive returns will startup the IPO issuance engine again. We believe that an extended period of positive returns for IPO investors is the most powerful solution to increasing IPO market activity leading to a greater presence of smaller sub-$50 million issuers. In the meantime, policies that assist these smaller IPOs to lower the cost of accessing the IPO market and improve IPO allocation to attract a broader base of long-term investors could provide some helpful relief.

* * * * *

Renaissance Capital's Recommended Improvements to the Proposed Legislation

1. Focus on the companies seeking to raise under $50 million that are currently shut out of the IPO market by properly defining Emerging Growth Company as smaller issuers seeking to raise up to $50 million.

2. Strike the proposed informational rules in S. 1933 Section 6 that permit IPO Underwriters and issuing companies to promote offerings and provide special information to selected clients during the IPO process to avoid re-creating the Internet bubble.
3. Encourage larger private companies (*e.g.,* Facebook) to file public disclosure (*i.e.,* go public) when active trading markets develop in its shares, by adding a public float requirement to the proposed private company legislation.

Recommendation #1: Refine the definition of "Emerging Growth Company" to focus on the small companies seeking to raise up to $50 million, replacing the proposed $1 billion revenue rule

The S. 1933 legislation defines Emerging Growth Company as a firm with $1 billion in revenue. By this definition, we would be giving relief to over 90 percent of the companies going public, effectively the entire IPO market, and would include companies with very large market capitalizations. The real Emerging Growth Companies that need to be targeted are smaller issuers seeking to raise under $50 million in capital. Based upon our analysis, an Emerging Growth Company should be redefined as one seeking to raise up to $50 million with an implied market capitalization under $200 million. This would target the part of the market that needs attention.

Recommendation #2: Strike the proposed rules that permit IPO Underwriters and issuing companies to promote offerings and provide special information to select clients during the IPO process

We agree that more research on companies would be favorable for stock trading, but Section 6 in the S. 1933 legislation, as written, would allow IPO Underwriters to engage in promotional activities. After the Internet bubble burst, investors suffered devastating losses of –49 percent and –61 percent in 1999 and 2000, respectively, from purchasing overvalued IPOs pumped up by underwriter research. Over 70 percent of the IPOs during that period were unprofitable companies, many of which went out of business. As we know from bitter experience, research by broker dealers and their affiliates that underwrite the IPO is inherently biased, used as a marketing tool to sell shares in the IPO and, without some restrictions, provides an informational advantage to the IPO Underwriters' research analysts and proprietary clients, contrary to Regulation FD.

Recommendation #3: Improve legislation expanding the size and dollar thresholds of the private placement market by adding another threshold that would encourage private companies, whose shares are actively trading, to go public

The various bills seeking to expand the size of the unregistered ("no-doc") private market from $5 million to $50 million and the number of accredited investors from 500 to 1,000, may help to open up more capital raising opportunities for smaller issuers. However, these changes may have the unintended consequence of creating a shadow IPO market of larger private companies. These private IPO-ready companies would reap the benefit of being public without taking on disclosure responsibilities. For example, even under the existing 500-shareholder limit, active private transactions in Facebook shares have occurred prior to its IPO filing at large cap valuations of $100 billion, the size of McDonald's. We recommend adding a provision to these new rules that encourage private companies (*e.g.,* Facebook), who meet certain thresholds of transactional activity, to go public, providing full disclosure to all investors. We support the market capitalization limit proposed by Columbia University Professor John Coffee of $500 million or less. This would help the IPO market.

Summary

A well-functioning IPO market is based upon the principal of full and honest disclosure of company information made available evenly to all public investors. The U.S. IPO market is functioning amazingly well under the stressful conditions of a global financial crisis. While there may be initiatives that can help improve the functioning of the IPO market, especially as it pertains to the most vulnerable smaller companies, the IPO market will heal itself starting with the larger, more established private companies. Waiving certain disclosure and stock promotion rules that could result in misallocating capital to weak or fraudulent companies will only endanger the recovery of the IPO market. It is the positive returns that investors earn from these larger issuers that will lead to more issuance for smaller IPOs.

PREPARED STATEMENT OF TIMOTHY ROWE

FOUNDER AND CEO, CAMBRIDGE INNOVATION CENTER

MARCH 6, 2012

Thank you for inviting me to speak today. As you know, I am the CEO and Founder of Cambridge Innovation Center (CIC). CIC houses approximately 450 startup companies in a large office tower in Kendall Square, Cambridge, Massachusetts. We are told that CIC has more startups under one roof than any other building anywhere. More than $1.5B dollars have been invested in these companies. We have been a launch-pad for several well-known companies, including Google Android and Great Point Energy.

I also serve as the President of the Kendall Square Association. Kendall Square is home to the Massachusetts Institute of Technology (MIT) and more tech and biotech companies per square mile than anywhere else in the world, and includes such global leaders such as Amgen, Biogen, the Broad Institute, Google, MIT, Microsoft, Novartis, Genzyme, VMWare, and the Whitehead Institute. Our goal is to ensure that Kendall Square remains a place where the world gathers to develop breakthrough discoveries that positively impact our society.

In other responsibilities, I serve on the investment committee for New Atlantic Ventures, a $120M early stage venture capital firm. Together with my partners, we have helped make dozens of investments in small companies.

This past December, Massachusetts was asked to send a delegation to the Startup America Summit at the White House to share what we believe to be the national priorities for helping grow jobs through entrepreneurship. Many Massachusetts leaders got involved, and together we settled on five key measures: 1) Crowdfunding, 2) IPO on-ramp legislation, 3) easier Visas for overseas entrepreneurs who want to come create jobs in the United States, 4) better mid-skills job training, and 5) limitations on noncompete agreements in employment contracts (some States already ban them). I was selected by the group to present our conclusions, and I will do my best to do so again today. Given the topic of today's hearing, I plan to talk about the first two measures.

We believe startups are at the root of restoring the United States to full economic health. As is now well known, a Kauffman Foundation study using U.S. Census data recently found that, over the last quarter century, all net new jobs in the United States have come from companies 5-years old and younger. Existing firms (those 6 years old and older) collectively lost jobs during that same quarter-century period analyzed (1980 to 2005). For every job lost by existing firms, new firms generated three. It seems clear that supporting startups and entrepreneurship is the key to job creation in the United States.

Enabling better access to capital will be the single most impactful step Government can take. I will speak in particular to two proposals:

1) Crowdfunding (S. 1791 and S. 1970)

Risk capital is distributed unevenly in our country. Startups do not today have adequate places to go to find the money to start a new business. Everyday businesses that are the bread and butter of our communities—businesses like restaurants, small construction companies and the like—are starved for capital. There are, for instance, nearly 8 million women-owned businesses in the United States, yet only a few hundred a year are able to raise venture capital.[1]

I believe that crowdfunding legislation can change this. As we have all heard, the Internet changes everything. One of the things that the Internet has changed is the ease with which an organization can broadcast its needs and attract supporters online. Another thing that has changed is that it is much harder for bad actors to hide from the scrutiny of the masses. Many companies have sprung up to help individuals and small businesses find loans, donations, and first customers this way. Politicians have found the Internet effective to raise campaign donations.

In an example that shows the power of crowdfunding, popular Web site Kickstarter, which collects money from fans to support principally film, arts and design-oriented projects, raised almost half as much money for the arts in 2011 as the National Endowment for the Arts (NEA). Due to its rapid growth, it appears likely to roughly tie the NEA in 2012.[2] The NEA acknowledged this, stating "Kickstarter

[1] Estimated to be between 140 and 280 deals per year based on data from the Kauffman Foundation at *http://www.kauffman.org/research-and-policy/gatekeepers-of-venture-growth.aspx* and *http://www.pwcmoneytree.com.*

[2] Analysis from Talking Points Memo at *http://idealab.talkingpointsmemo.com/2012/02/the-nea-responds-to-kickstarter-fundingdebate.php?m=1.*

and the other platforms that crowdsource donations for arts organizations and projects are becoming increasingly important in helping the arts."

Crowdfunding proposes to harness this same power to help people start new businesses, and create new jobs. It will enable individuals to make small equity investments in others' businesses without the usual regulatory burdens associated with a public offering.

Many of us in the startup community believe that such a mechanism will allow far more startups to get going in the United States, thereby creating much-needed new jobs. This is evidenced by a petition started by some entrepreneurs in my center, which can be found at *Wefunder.com.* They obtained commitments from more than 2,500 individuals to invest over $6M through crowdfunding.

How big could the impact of crowdfunding be? Americans have about $30 trillion dollars in savings plans (401Ks, IRAs, and the like). Amy Cortese, author of the book *Locavesting,* points out that if Americans diverted just 1 percent of this amount into crowdfunding type investments, the amount raised would equally half of all small-business loans in the country, and would be about 10 times the total amount of venture capital invested each year in the United States. The potential benefit to the country from this is very large.

The chief concern with crowdfunding is the threat of fraud. Some have voiced a concern that unscrupulous individuals might take advantage of unsophisticated investors, misrepresenting risks, and effectively stealing investors' money.

While this concern is understandable, the data show that Internet intermediaries have been successful at blocking such fraud. United Kingdom-based crowdfunding startup Crowdcube, for instance, reports zero fraud claims after a year in business (see attached letter from its CEO). They achieve this in part by thoroughly vetting the opportunities they present for investment. Similarly, *Prosper.com,* a crowd-lending business operating under SEC regulation claims to have raised $124M in loans and to have no reports of fraud or misrepresentation. Funding Circle, out of the U.K., another crowd-lending platform, claims to have raised £26M in 569 transactions and reports no fraud (and only 5 defaults so far). AngelList is a crowdfunding platform in the United States that works only with accredited investors. It operates under the SEC's Regulation D, and has raised "more than $100M" in equity investments using its online platform. AngelList claims zero reports of fraud. Net-net, I conclude that if crowdfunding legislation requires that any investments be made through an SEC-licensed intermediary, the fraud problem can be resolved.

To draw a broader analogy from a different industry, as we all know, eBay is a Web site that permits one to buy items from people they have never met, and never will meet, based solely on an online description. On the face of it, this would similarly seem to be a hotbed for fraud. Yet any eBay user will tell you that the incorporation of a system that tracks the reputation of buyers and sellers significantly mitigates fraud. We believe that the analogous mechanisms will be developed by competing crowdfunding intermediaries, leading to an enviable investment environment that is safe and free from undue regulation.

To the extent that there are continued concerns about fraud, one additional attractive market-based solution could be fraud insurance. Given the low actual incidence of fraud, crowdfunding proponents have attracted the interest of insurers who have voiced an openness to issue policies protecting crowdfunding investors against fraud.

I understand that there are efforts underway to create a "consensus" crowdfunding bill that would incorporate the best of the various bills under consideration. Having studied the topic closely, I would urge the drafters to do so, and to incorporate the following provisions:

a) *Require the use of SEC-licensed intermediaries.* Intermediaries, playing the "eBay" role, are the key to eliminating fraud. Intermediaries will compete to be attractive to investors, offering such incentives as anti-fraud insurance. Intermediaries would creatively develop competing mechanisms to reduced fraud, be that by manually vetting the deals, or using some other mechanism such as crowd input. I don't think we should legislate how the do it, since this is an area where we want creative innovation. Instead, any intermediaries deemed ineffective at eliminating fraud would simply be subject to losing their license. It is important that the regulations that intermediaries should be subject to enable them to flexibly, and at low-cost handle these small transactions (*e.g.,* not subject to the full brunt of onerous broker-dealer regulations, but only the specific intermediary requirements spelled out in the bills, which all look fine). To the extent that a workable definition of such an intermediary can be agreed upon, ideally it would also be extended to the afore-

mentioned Reg-D-based crowdfunding intermediaries as well, since they face the same issues.

b) *Enable investments larger than $1,000 for those who can afford it.* Some of the proposed bills provide formulas for determining limits. Data show that 90 percent+ of the dollars raised in crowdfunding initiatives are from people investing more than $1,000, so it is highly desirable to enable larger investments. See attached chart. One way to address this concern would be to set a higher limit, say $100,000, or no limit, on the amount accredited investors can invest under crowdfunding legislation, effectively extending this same concept of crowdfunding through intermediaries to cover both crowdfunded & accredited investments.

c) *Don't burden the process with unnecessary restrictions that would render crowdfunding legislation meaningless.* For instance, it is essential that the degree of interaction required with individual States be limited. Fifty States and 50 different sets of rules, and these small companies can't handle that amount of complexity. Limited State filings for the issuer's State and a State in which the majority of the issuer's investors live are reasonable, but, in general, it is imperative that State securities laws be preempted by the crowdfunding exemption (with the exception of State anti-fraud laws). Additionally, it is important that overly burdensome disclosure obligations are not placed on issuers. These rules were created with large issuers in mind, and would stifle crowdfunding. Instead, follow the example of Crowdcube-they have a strong incentive to eliminate fraud and do not list opportunities they believe to be inadequately described, or where stories don't check out.

d) *Don't burden crowdfunding issuers with excessive liability.* Issuers should be subject to collective action by investors if they commit wrongs, but some provisions would appear to create the possibility for individual rights of action, and that would create an untenable risk for issuers.

e) *Do require a periodic ongoing review of how this is going,* as called for in S. 1970.

2) IPO on-ramp legislation (S. 1933)

While most jobs are created by companies 5-years old and younger, an exception is larger companies that go public and raise substantial amounts of capital. Data show that companies that go public grow their headcount approximately 5-fold, often creating thousands of jobs.

Unfortunately, the current regulatory frameworks impacting public companies have had the unintended consequence of substantially reducing the number of companies that are able to go public. It costs an estimated $2.5M for a company to go public today, and $1.5M per year to stay public. These are heavy burdens for young companies to bear.

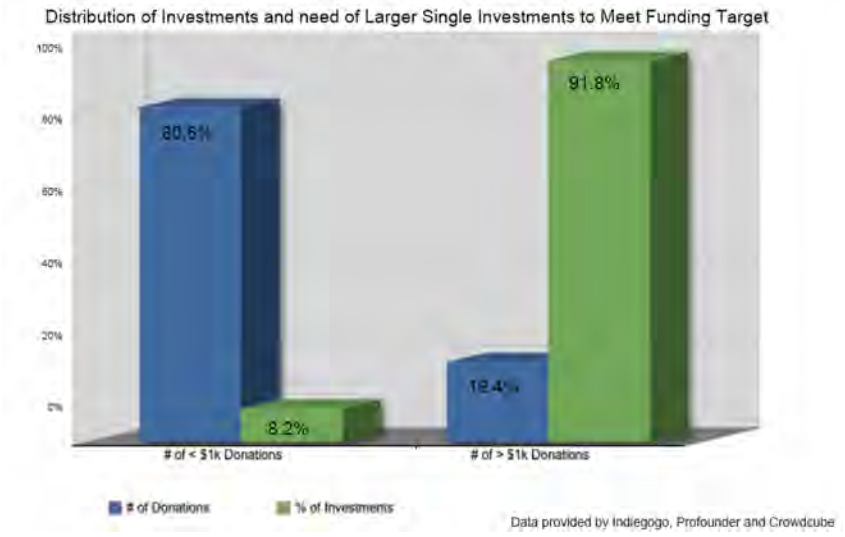
Proposed legislation would reduce this regulatory and paperwork burden for so-called "Emerging Growth Companies": smaller, younger companies that are less likely to go public otherwise. This category, by virtue of being comprised of young companies, today represents only a small 3 percent of the total value of publicly traded companies. At the same time, it represents our future. It is important that we nurture it.

Under this proposal, regulation would "scale", growing with a company's compliance abilities. I believe it is important to note that I personally applaud the intent of many of the regulations that are scaled under this bill. I believe each regulation was created with good intentions, and under the proposed legislation, each will, in time, be applied to every company that goes public. This bill simply delays the day that these companies must face the economic burden of compliance.

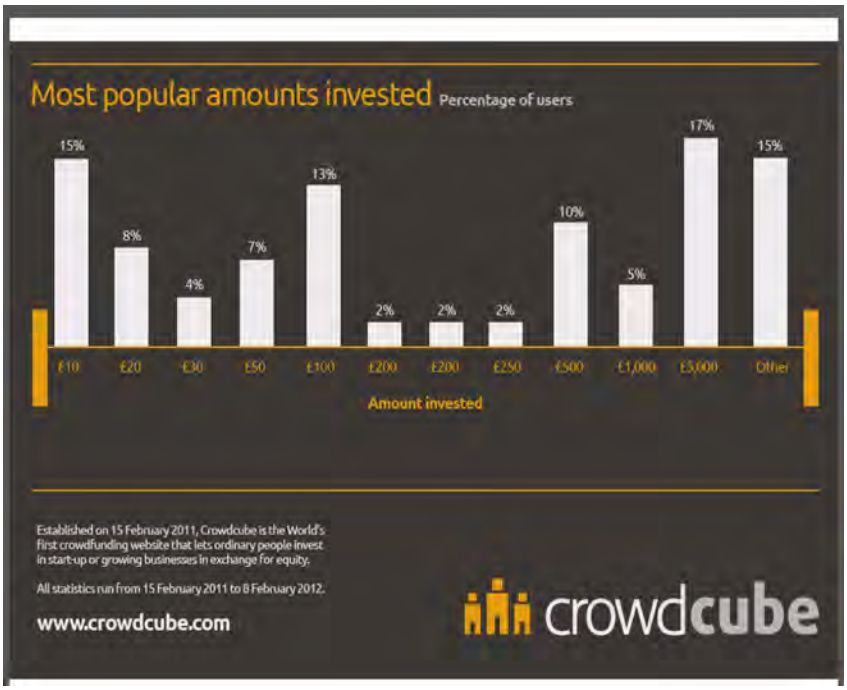
I am hopeful that the Senate will find these proposals have merit and that Congressional enactment is necessary to jumpstart our economy. This is a time when we must be creative and work together to find solutions to help America get back to work.

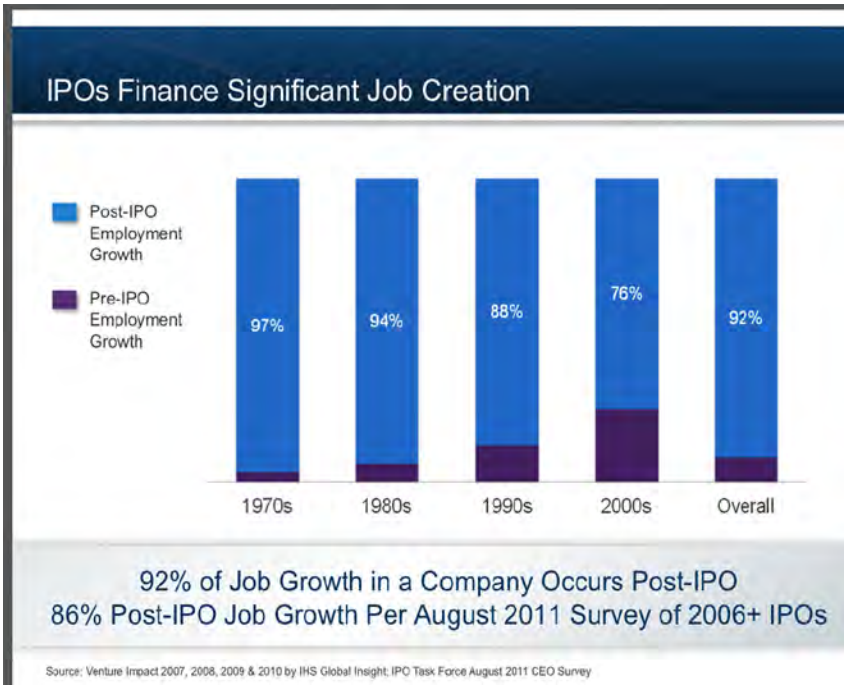
Without investments over $1000 Crowdfunding doesn't work

Investments over $1000 make up 91.8% of capital raised



Data provided by Indiegogo, Profounder and Crowdcube




IPOs Finance Significant Job Creation
Post-IPO Employment Growth
Pre-IPO Employment Growth
97%
94%
88%
76%
92%
1970s
1980s
1990s
2000s
Overall
92% of Job Growth in a Company Occurs Post-IPO
86% Post-IPO Job Growth Per August 2011 Survey of 2006+ IPOs
Source: Venture Impact 2007, 2008, 2009 & 2010 by IHS Global Insight; IPO Task Force August 2011 CEO Survey

crowdcube
The Innovation Centre | University of Exeter | Exeter | Devon | EX4 4RN

2nd March 2012

To whom it may concern,

My name is Darren Westlake and I am the CEO of Crowdcube Limited. We are the world's first crowdfunding for equity service and we are based in the UK.

Crowdcube launched its service in February 2011 and since then our service has gained huge momentum and has been acclaimed across the UK and Europe as a pioneer in the arena of start-up finance.

Let me share some of the statistics that represent the first year of Crowdcube:

- 757 companies have applied to list on Crowdcube
- 185 companies were approved to list on Crowdcube (over 75% of applicants were vetted out)
- 15 businesses have been successful in raising money
- £2.68m ($4.24m) has been successfully raised
- £3.37m ($5.34m) has been invested in companies
- None of our successful companies have been fraudulent in any way and so far all have gone on to make good use of their funding and we have excellent feedback from investors

If you need any further information or insight from me please do not hesitate to get in touch.

Kind regards,

Darren Westlake

CEO, Crowdcube Ltd.

AngelList

188 King Street, San Francisco, CA

March 05, 2012

To whom it may concern,

My name is Naval Ravikant. I'm the co-founder and CEO of AngelList. We are the world's largest platform for early stage startups and qualified, accredited investors to meet each other, and are bringing the Silicon Valley ecosystem online and making it available to the entire country.

Since launching in February 2010, we have facilitated over 15,000 introductions between over 3,000 accredited and sophisticated angel investors and thousands of startups. Over 20,000 startup profiles are on our platform, and over a thousand have raised more than $100 Million, spread around the entire US.

Since AngelList does not handle the money or take a transaction fee, we are not privy to the transaction details or to the outcomes. However, dozens of the companies have gone on to be acquired or raise large subsequent financing rounds, and a number, including Pinterest, BranchOut, Uber, and others have become very successful enterprises in their own right.

To date, we have received no word that any of the companies have defrauded investors or absconded with funds.

If you would like to discuss further, please feel free to contact me anytime.

Best,
Naval Ravikant

CEO, AngelList

PROSPER.COM 111 SUTTER STREET, 22ND FLOOR SAN FRANCISCO, CA 94104 (P) 415 593-8400 (F) 415 362-7235

March 5, 2012

To whom it may concern,

Prosper Marketplace Inc., a peer-to-peer lending marketplace that brings together creditworthy borrowers with individual and institutional investors, allows people to lend to each other in a way that is financially and socially rewarding. Individual and institutional investors lend in minimum increments of $25 on loan listings they select. In addition to credit scores, ratings and histories, investors can consider borrowers' personal loan descriptions, endorsements from friends, and community affiliations. Prosper handles the servicing of the loan on behalf of the matched borrowers and investors.

Since January 1, 2010, Prosper has facilitated the origination of over $124M in loans through its platform. As of February 29, 2012, the rate of fraud relating to identity theft for these loans has been 0.0% and Prosper has not been required to repurchase any of the loans due to identity theft.

Prosper was co-founded by Chris Larsen, co-founder of E-LOAN. Prosper has raised $83.85 million in venture capital and is backed by financial and technology luminaries including, Tim Draper of Draper Fisher Jurvetson; David Silverman of Crosslink Capital; Accel Partners; CompuCredit; Omidyar Network; Capital One Co-founder Nigel Morris of QED Investors; Court Coursey of TomorrowVentures; and Larry Cheng of Volition Capital.

Sincerely,

Chris Larsen
CEO & Chairman
Prosper.com

PREPARED STATEMENT OF LYNN E. TURNER

FORMER CHIEF ACCOUNTANT OF THE SECURITIES AND EXCHANGE COMMISSION, AND MANAGING DIRECTOR, LITINOMICS, INC.

MARCH 6, 2012

Thank you Chairman Johnson and Ranking Member Shelby for holding this hearing and it is an honor to be invited to testify before you. I am sure everyone here at the hearing today can agree that increasing employment in the United States, and bringing back jobs that have left the country, is vitally important to our economy and the well being of America, and Americans. The destructive effect of the most recent financial crisis on American jobs, the United States (U.S.) capital markets, retirement and savings accounts, and families provides us stark lessons in this regard, if we choose to learn from them, rather than repeat them.

Background

- Let me begin by noting my comments today are framed by my past experiences including:
- Having been involved as an executive in starting up a successful venture backed company that created jobs.
- Having served on a Commission formed in my State in the 1980s to explore what could be done to improve the success rates of startup businesses and smaller companies.
- Serving as a trustee for two institutional investors, including on the investment committees. One of those institutions does invest in startup and/or growing companies via investments in venture capital and private equity.
- Serving as the U.S. Securities and Exchange Commission (SEC) Chief Accountant, responsible for advising the SEC Chairman and Commission on matters of disclosure, transparency and auditing affecting all public companies.
- Serving as a Vice President and Chief Financial Officer at a semiconductor and storage systems company. Attracting capital and financing was critical to the company's success as we made major investments and purchases in manufacturing plants and the jobs in them. We spent 2 years preparing for an Initial Public Offering (IPO), including preparation of filing documents, selection of underwriters, and working with sell side analysts as they wrote research reports in anticipation of the offering. Ultimately, due to the downturn brought on by the Asian Crisis and its contagion effect on the capital markets, the IPO was not completed.
- Spending 20 years of my career with a Big 4 accounting and consulting firm, including spending considerable time in the Emerging Business Services Group that advised and audited emerging and growing businesses. This included working with companies inside two business incubators in Boulder and Denver Colorado for which the Boulder Incubator Board presented me with the Board Partnership Award.

Initial Public Offerings

Public offerings of stock by companies to investors are an important factor in the success of our capital markets. The number of offerings completed, as well as the amount of money raised, tracks the economy in general. This was noted in the Goldman Sachs Global Economics Weekly report February 7, 2007 which stated:

> Several recent reports have fuelled anxiety that Wall Street is losing out . . . most keenly to London and is doomed to lose its perch as the world's pre-eminent capital market. Studies have pointed to strict legal and regulatory practices in the United States as reasons why issuers are increasingly looking elsewhere for IPOs. These issues are typically contrasted with London's light touch regulation, more hospitable legal regime and ease of migration.
>
> The regulatory climate does matter, and policy reform might strengthen New York's competitiveness. Nonetheless, we do not think this is the main problem nor indeed that Wall Street is losing out in a regrettable way. Instead we see the growth of capital markets outside the United States as a natural consequence of economic growth and market maturation elsewhere. The United States has in fact been losing market share for several decades, and it trails Europe in trading of FX and many derivatives."
>
> Legal and regulatory factors probably do matter, and policy reform might strengthen New York's competitiveness. Nonetheless, we do not see them

as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more.

The reason IPO's track the economy is that investors invest to earn a return. When the economy is growing, companies can grow. That growth in revenues, profits, cash and investments such as employees fuels the growth in companies' stock and the returns investors seek. However, when the economy has stalled or is declining, and companies are not growing, investors simply cannot achieve the types of returns they need to justify making an investment. The following chart highlights that. As a result of the downturns in the economy that occurred during much of the 1970's brought on in part by withdrawal from Vietnam, the recession brought on by inflation at the beginning of the 1980s, the dot com bubble and corporate scandals, and the most recent great recession, investors became concerned about returns that could be earned in the markets and IPO's declined. As the economy and employment have recovered after each of these downturns, so has the IPO market.

Chart 1

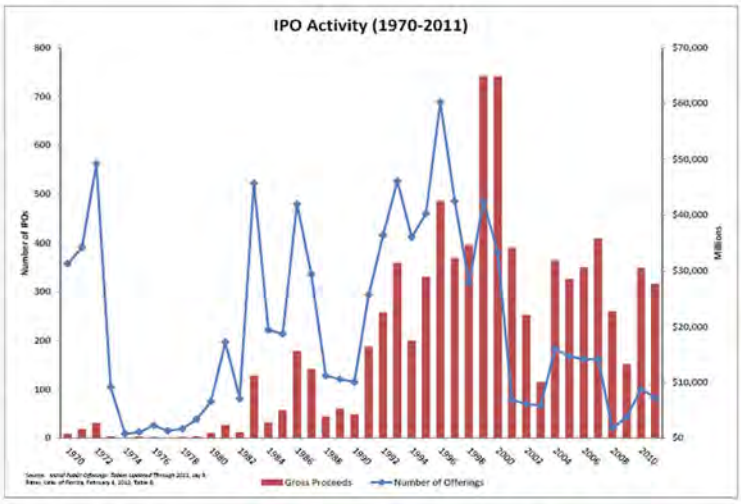
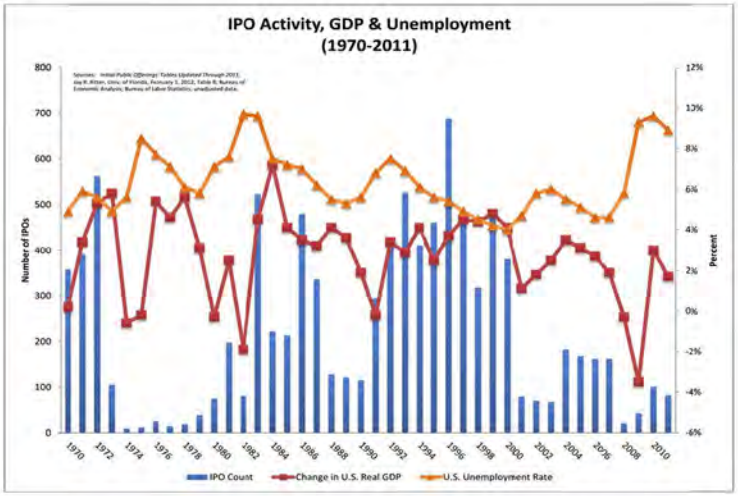


Chart 2



During the 1990s, the U.S. economy experienced high growth rates, which has not since been matched. Charts 1 and 2 illustrate how the IPO market reached an unprecedented level during the 1990s not achieved before or after. Some argue that is because the U.S. regulations protecting investors are overly onerous. Often they cite Sarbanes-Oxley and its Section 404(b) requirement for companies, mandating an audit of their internal controls as an unjustified cost. But the facts simply don't bear this out, and those arguments have a lot in common with the too common refrain—"the sky is falling." Those making this argument also cite the London AIM market as an example of a "lightly" regulated market the United States should attempt to emulate.

However, a close examination of the issue does not support these individuals. First of all, the U.S. IPO market had very significant declines in the 1970s, 1980s, and as the last century came to a close. Some of those declines occurred before current regulator financial reporting requirements were adopted, and certainly before Sarbanes-Oxley was adopted in 2220. In addition, if one looks at the following charts for the AIM market, one can see that market also experienced deep declines in its IPO market.

And its recovery has significantly trailed those in the United States as the U.S. economy has outperformed that in Britain. One can only ask, why would a reasoned and thoughtful person want to copy that?

Chart 3

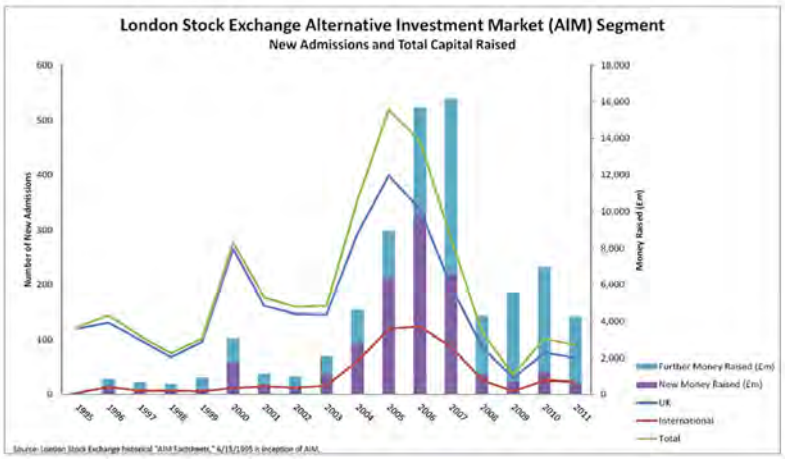
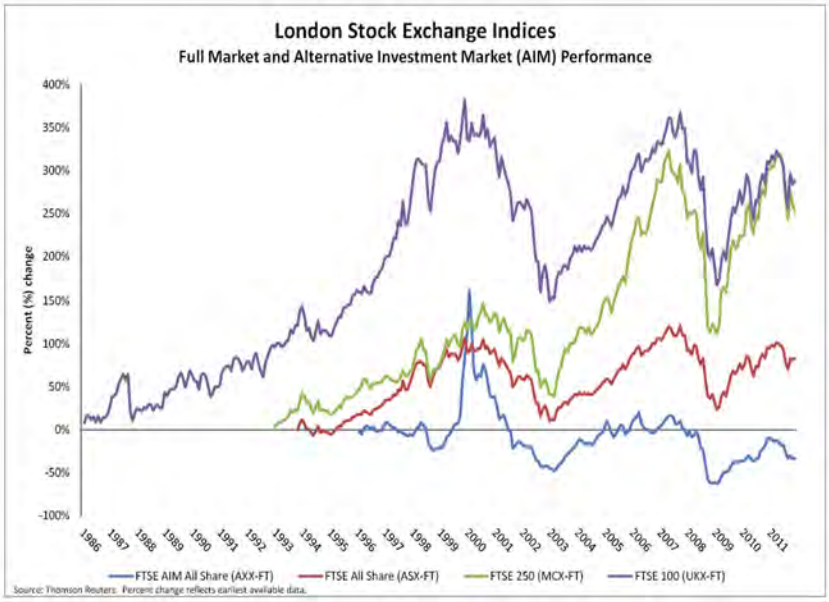


Chart 4

A number of years ago, a former SEC Commissioner caused a ruckus when he made reference to the AIM market as being somewhat akin to a Las Vegas Casino. He had a point. As noted in the following chart, this lightly regulated market was started in the 1995/96 timeframe. If one had invested in the AIM market index at the time with a $1,000, one would no longer have the $1,000, as the market has generated a negative return for investors. It is no surprise then that The Daily Telegraph in the U.K. recently stated that: "Recent research for *The Daily Telegraph* has also shown that at least 80 leading money managers do not have confidence in the current regulation of natural resource companies on AIM." (See Exhibit 1).

Chart 5



Despite a market that has risen from the despair of 2009, investors remain cautious about giving their money to companies. The aggregate returns they have earned since 1999 have been somewhat meager when compared to the 1980s and 1990s. Baby boomers have seen their 401–K's turned into 201–K's by the scandals and dot com bubble at the beginning of the last decade with the most recent financial crisis burning them badly. Both the Nasdaq and Dow Jones Indexes remain well below their highs. And just a couple of weeks ago, an article in the Wall Street Journal noted that in 37 of the past 40 weeks, investors had pulled cash out of investments in small cap companies.

Again, investors invest to make a reasonable return. But just as such returns have been fleeting for them, they have also been lower for Venture Capitalists (VC's). My experience has shown that VC's are astute at picking the companies and management teams to invest in, that will yield them and the investors in their funds, the highest possible returns. And they bring great insights and expertise to these companies, greatly aiding them in their efforts to grow and become highly successful. Yet despite all this experience, knowledge and expertise, as noted in the following chart, VC's and the investors in their funds have experienced the same impact from the downturns in the economy everyone else has. And that should be no surprise to anyone who understands fundamental, basic economics. It takes a growing economy such as existed in the United States in the 1990s, and exists now in China, India and certain other emerging countries in the world, to generate returns for investors.

Chart 6

Critical Success Factors for an IPO

I have often counseled that not all companies should do an IPO. If you take someone's money, you should do so ***ONLY*** if you think it is likely, you will be able to yield them a reasonable return on their money. After all, they are owners of the business once they have bought stock and should be treated accordingly. Those who go public thinking that "possession is 9/10ths of the law" when it comes to cash, are in for a very rude awakening.

When I served on a Colorado Commission that explored why so many small companies were failing in Colorado at the time, and how their success rate could be improved, we found that access to capital was not the primary cause of failure. Rather it was a lack of sufficient expertise and management within the company including in such areas as marketing and operations. While access to sufficient capital for any company is important, I have found that those emerging companies with better management teams and proven products, or products with great growth potential, are able to obtain it. Those are the types of companies VC's and private equity seek out.

My experience has also taught me that many IPO's are not a success. We are all very mindful of the Googles, Apples, HP's, and Microsofts that have become great successes. In fact, the vast majority of the jobs they created have been created after an IPO, not before.

In an American Enterprise Institute Paper titled "Are Small Businesses The Engine of Growth" Veronique de Rugy, the author states:

> It is a common belief among entrepreneurs and policymakers that small businesses are the fountainhead of job creation and the engine of economic growth. However, it has become increasingly apparent that the conventional wisdom obscures many important issues. It is an important consideration because many Government spending programs, tax incentives, and regulatory policies that favor the small business sector are justified by the role of small businesses in creating jobs and is the *raison d'etre* of an entire Government agency: the Small Business Administration (SBA). This paper concludes that there is no reason to base our policies on the idea that small businesses are more deserving of Government favor than big companies. And absent other inefficiencies that would hinder small businesses performances, there is no legitimate argument for their preferential treatment.

And in the paper titled "What Do Small Businesses Do?" professors Erik Hurst and Benjamin Wild Pugsley state:

> In Section 3 of the paper, we study job creation and innovation at small and/or new firms. First, using a variety of data sets, we show that most surviving small businesses do not grow by any significant margin. Most firms start small and stay small throughout their entire lifecycle. Also, most surviving small firms do not innovate along any observable margin. We show that very few small firms report spending resources on research and development, getting a patent, or even copywriting or trade marking something related to the business (including the company's name). Furthermore, we show that nearly half of all new businesses report providing an existing good or service to an existing market. This is not surprising in light of the most common small businesses. A new plumber or a new lawyer who opens up a practice often does so in an area where existing plumbers and existing lawyers already operate.

They go on to conclude:

> Recognizing these characteristics common to many small businesses has immediate policy implications. Often subsidies targeted at increasing innovative risk taking and overcoming financing constraints are focused on small businesses. Our analysis cautions that this treatment may be misguided. We believe that these targets are better reached through lowering the costs of expansion, so they are taken up by the much smaller share of small businesses aspiring to grow and innovate. In fact, the U.S. Small Business Administration already partners with venture capitalists whose high powered incentives are aligned with finding these small businesses with a desire to be in the tail of the firm size distribution.

In fact, during the heydays of the IPO market of the 1990s, many companies went public and took money from investors that never should have. Yet shortly after going public, as Exhibit 2 notes, many failed, causing investors great losses in their retirement and college education savings accounts, and destroyed over a hundred thousand jobs. Many large pension funds have never been able to recover to their pre dot com bust funding levels, leaving Americans wondering where the money will come for their retirement.

At the height of the bubble, leadership of the Business Roundtable invited then SEC Chairman Arthur Levitt and me to dinner. At the dinner, they urged us to prohibit many of these companies from taking investors money. (The SEC did not have that regulatory power as the United States appropriately has a disclosure rather than merit based system.) They argued that rather than the investments going to companies who could put it to good use, investing in plants, jobs and research, the money was flowing into young, unproven companies that lacked adequate management, let alone revenues, profits and a substantive business plan. They turned out to be right. The capital was poorly allocated, and many American investors, businesses and workers paid a stiff price.

Not too long after that, I had lunch with a managing director of one of the "Bulge Bracket" investment banks who had done many public offerings. By that time the market had cratered taking trillions of dollars of wealth with it. He said that in fact, Wall Street, the venture capitalists, attorneys and other gatekeepers, had facilitated the IPO of many companies that never should have gone public. He went on to say that whereas before the IPO market bubble got way out of hand, companies had to have attained at least certain levels of revenues for an established period of time, to demonstrate they were viable companies who could earn a reasonable return for their investors. But in the bubble, he said all that was thrown out the window, and any company they could take public they did. When I asked him why, he responded "Because if we didn't do it, the next guy would!"

Conclusion on Legislation

For any capital market to work effectively, it must provide investors with high quality, timely and complete financial information that is accurate. Conflicts inherent in the markets must preferably be prohibited and at a minimum must be clearly and completely disclosed to all participants. And there must be an enforcement mechanism that ensures a fair and orderly market.

In the past, the U.S. capital markets have had a reputation for appropriate regulatory and enforcement mechanisms, and continues to attract capital, including from foreign investors. But the scandals of the last decade has damaged our reputation, beginning with the dot com IPO market bubble, to the Wall Street analysts scandal, to mutual fund market timing and trading frauds, to Madoff and other ponzi

schemes, along with the once in a lifetime financial crisis brought on by extremely lax regulation by securities and banking regulators, and by people who originated bad loans, collected huge fees for doing so and then sold the worthless paper to investors.

Lax regulation, in some cases the result of acts of Congress, has hammered the investment accounts of retirees and baby boomers that no longer have sufficient time to recover from the losses incurred. Laws that were passed by this Committee, including the Gramm-Leach-Bliley Act, and the Commodities Modernization Act of 2000, which prohibited regulation of derivates; were driving factors behind too big to fail companies; and resulted in a $600 trillion dollar unregulated derivatives market, both of which AIG and Lehman engaged in. These laws neither protected investors nor taxpayers, but certainly did allow them to be taken advantage of. It is not sufficient to say legislation will protect investors, it must actually do it.

As I review the legislation before the Committee, I find it reduces the level of transparency and amount of information investors will receive. It removes critical investor protections put in place to protect against a repeat of past scandals. It decreases the credibility of the information one will receive. It not only allows market participants such as analysts to once again engage in behavior and activities that were associated with prior market disasters, it treads on the independence of independent standard setters such as the Public Company Accounting Oversight Board (PCAOB) established by this Committee, as well as the Financial Accounting Standards Board (FASB). If ill-conceived amendments regulating the cost benefit analysis the SEC would have to perform, that were adopted in the U.S. House of Representatives, I suspect investors would be well served to understand that handcuffs had been put on the SEC, rather than bad actors.

The proposed legislation is a dangerous and risky experiment with the U.S. capital markets, and the savings of over 100 million Americans who depend on those markets. The evidence does not support the need for it. In fact, it contradicts it. I do not believe it will add jobs but may certainly result in investor losses. If jobs are created, as the evidence above indicates, it will come from growth in the economy, not this legislation. And finally, there has not been the type of cost benefit study performed with respect to the proposed legislation that Congress itself mandates the SEC must do before adopting such regulations. Senator Shelby has been correct in noting there was insufficient study performed before enactment of Dodd/Frank. There has been even less study of the bills that are the subject of this hearing today.

As a result, I do not support the various bills including the IPO on ramp and crowd funding legislation. I share many of the concerns voiced by others including the Council for Institutional Investors, Consumers Federation, Americans for Financial Reform, AFL–CIO to name a few. Their concerns are set forth in greater detail in Exhibit 3 which I include for inclusion in the record.

Comments on Particular Bills

I do offer the following specific comments on the legislation for your consideration.

Senate Bill 1933.

Section 2 Definitions

The definitions included in this bill would make it applicable to companies under $1 billion in revenue, and $700 million in market capitalization, for up to 5 years or until they broke those thresholds. While these companies are defined as "emerging', that is serious a misnomer. As the charts below illustrate, this would scope in over 98 percent of all IPO's. And the vast majority of public companies currently filing periodic reports are under these thresholds according to raw data from Audit Analytics.

Chart 7

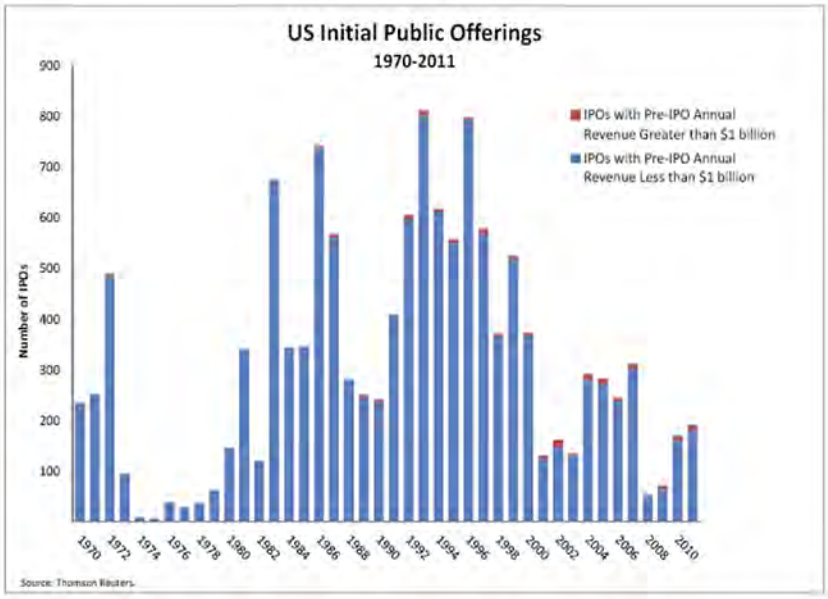


Chart 8

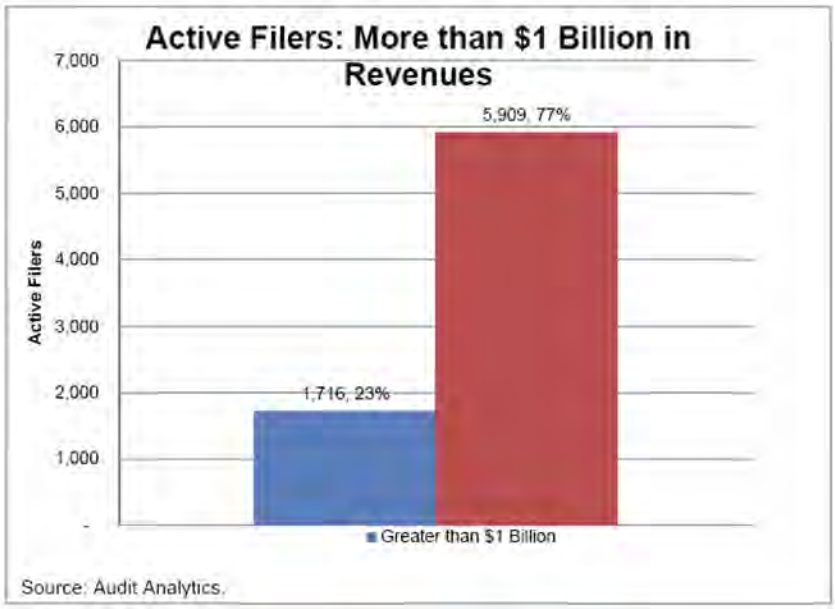


Chart 9

Given the nature of the experiment being run through this proposed legislation, I would strongly urge the threshold be reduced to $75 million. Experimenting with such a large segment of public companies and IPO's, as the proposed thresholds would, is highly risky and chances putting millions of Americans at risk.

Section 3 Disclosure Obligations

This section would reduce by a third, the amount of credible, audited financial information investors would receive. That information is the lifeblood of the capital markets and necessary for making informed decisions on where capital should be allocated. Yet this vital information is proposed to be seriously restricted by this legislation.

My experience tells me that successful IPO's, are done by companies with sufficient track records to demonstrate they are worthy of an investment. If a company has been established for more than 2 years, then it should continue, as has been the practice for decades, to present 3 years of audited financial information to investors. If companies are unable to do this, I would be seriously concerned if they are ready for the "prime time" of being a public company, and are not likely to generate sufficient returns to warrant an investment.

This section also impinges on the independence of the FASB as it exempts emerging companies from having to adopt new accounting pronouncements. As a result, if the FASB were to adopt a new pronouncement in response to a significant problem such as the off balance sheet special purpose entities of Enron or the off balance sheet reporting at Lehman, emerging companies may well avoid having to implement such standards for a period of time, leaving investors once again in the dark.

As noted at Exhibit 4, Senator Shelby has correctly defended the independence of standard setters such as the FASB. His counsel should be heeded once more and this provision regarding accounting pronouncements should be removed from the legislation.

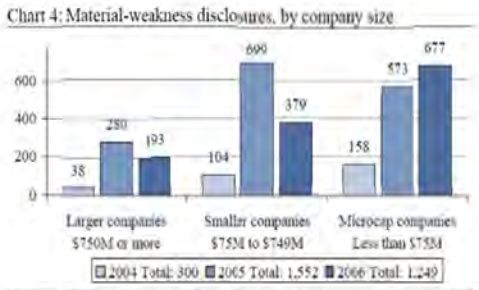
Section 4 Internal Controls Audit

As discussed earlier, Sarbanes-Oxley Section 404(b) has not been the reason there has been a decline in the number of IPO's. Companies under $75 million in market capitalization have never had to implement SOX 404(b) so it cannot be the reason such companies have not gone public. And for those companies that do go public, they have not had to implement SOX 404(b) at the time of the IPO or at the subsequent annual report filed with the SEC. It is only at the time of the second annual report that a public company must complete an audit of its internal controls. This

is a reasonable exemption from the requirements of SOX 404(b) that should be retained rather than replaced.

Data has clearly demonstrated that prior to the enactment of SOX, thousands of companies were not complying with the internal control provisions of the Foreign Corrupt Practices Act of 1977. As SOX was implemented, the chart below highlights the numbers of companies that were found not to have complied with the law. SOX 404(b) did bring much greater transparency to the number of companies that had inadequate internal controls, and that as a result, had to correct their financial statements.

Chart 10



Source: Glass Lewis, company filings, Reuters. Note: Company size determined by market capitalization as of filing date. Larger companies include those with $750M or more in market capitalization. Smaller companies include those with $75M to $749M in market capitalization. Microcap companies include those with less than $75M in market capitalization.

Source: Glass Lewis report, The Materially Weak

As SOX 404(b) was implemented, erroneous financial statements, that in most instances had previously been attested to by the executives, came to light in record numbers. In a February 2007 report by Glass Lewis, where I was the Vice President in charge of the research, found:

> Companies with U.S.-listed securities filed 1,538 financial restatements in 2006, up 13 percent from what had been a record number in 2005. About one out of every 10 public companies filed a restatement last year, compared with one for every 12 in 2005. Of the latest restatement batch, 118 were by foreign issuers.
>
> If there was any lingering question about whether these figures matter, consider this: The median stock return of companies that filed restatements last year was minus 6 percent. That was 20 percentage points lower than the return of for the Russell 3000 stock index in 2006.

The report went on to list key findings:

Key Findings

- 1,244 U.S. companies and 112 foreign companies—1 of every 10 companies with U.S.-listed securities—filed 1,538 financial restatements to correct errors
- 2,931 U.S. companies, about 23 percent, filed at least one restatement during the last 4 years; 683 companies restated two or more times
- Restatements by companies required to comply with SOX 404 declined 14 percent; restatements by non-SOX 404 companies rose 40 percent
- Difference in audit fees between SOX 404 and non-SOX 404 companies pales in comparison to cost of corporate accounting frauds and executive compensation
- One-third of larger companies and two-thirds of microcap companies that restated still claimed to have effective internal controls over financial reporting
- The median 1-year stock return of companies that restated last year was 20 percentage points lower than the return of the Russell 3000 stock index in 2006.

Companies with deficient internal controls tend to be poorly managed companies that underperform their peers in the markets, and which yield lower returns to investors. Accordingly, information on the quality of internal controls is very important to investors. The chart below highlights this issue, and notes that investors in

companies that have poor internal controls and restatements cost investors dearly. However, those who question the costs of SOX 404(b) often disregard such data, caring only about the cost to the company and not the huge economic benefit to investors.

Chart 11

Table 14: One-year stock price performance of companies with restatements and material weaknesses

Group of companies	Number	Median % total return	Dow % total return	S&P 500 % total return	Russell 3000 % total return	NYSE Composite % total return	Nasdaq Composite % total return	% underperformed Russell 3000
2004 material weaknesses	263	-6.2	3.1	9.0	10.1	12.6	8.6	-16.3
2005 material weaknesses	1,126	-10.9	-0.6	3.0	4.3	7.0	1.4	-15.2
2006 material weaknesses	945	-3.9	16.3	13.6	13.7	17.9	9.5	-17.6
2004 mat. weak. with restatements	133	-9.6	3.1	9.0	10.1	12.6	8.6	-19.9
2005 mat. weak. with restatements	647	-9.2	-0.6	3.0	4.3	7.0	1.4	-13.5
2006 mat. weak. with restatements	537	-3.1	16.3	13.6	13.7	17.9	9.5	-16.7

Source: Glass Lewis, FactSet, company filings. Note: Total returns calculated over calendar years, from Dec. 31 to Dec. 31. Material weaknesses were associated with restatements if the disclosures occurred within one year of each other.

Source: Glass Lewis report, The Materially Weak

The General Accountability Office and SEC have also issued studies and reports on their findings on the benefits of SOX 404(b). One such report captioned "United States General Accounting Office Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (**October 2002**) FINANCIAL STATEMENT RESTATEMENTS Trends, Market Impacts, Regulatory Responses, and Remaining Challenges" GAO–03–138 found:

> The 689 publicly traded companies we identified that announced financial statement restatements between January 1997 and March 2002 lost billions of dollars in market capitalization in the days around the initial restatement announcement. For example, from the trading day before through the trading day after an initial restatement announcement, stock prices of the restating companies that we analyzed fell almost 10 percent on average (market adjusted). We estimate that the restating companies lost about $100 billion in market capitalization, which is significant for the companies and shareholders involved but represents less than 0.2 percent of the total market capitalization of NYSE, Nasdaq, and Amex. However, these losses had potential ripple effects on overall investor confidence and market trends. Restatements involving revenue recognition led to greater market losses than other types of restatements. For example, although restatements involving revenue recognition accounted for 39 percent of the 689 restatements analyzed, over one-half of the total immediate losses were attributable to revenue recognition-related restatements. Although longer term losses (60 trading days before and after) are more difficult to measure, there is some evidence that restatement announcements appear to have had an even greater negative impact on stock prices over longer periods. The growing number of restatements and mounting questions about certain corporate accounting practices appear to have shaken investors' confidence in our financial reporting system.

This finding is very consistent with research and findings of the Staff of the SEC while I was Chief Accountant. As a result, I believe the data clearly supports that the benefits of SOX 404(b) to investors significantly outweigh the costs. Congress should conduct a cost benefit test, consistent with what it mandates of the SEC, if it exempts any additional companies from SOX 404(b).

Section 5 Auditing Standards

Section 5 is troubling for two reasons. First, Congress established the PCAOB to regulate auditors of public companies. At the time it did so, it acknowledged that such an entity would be able to do a better job of that than Congress itself.

The PCAOB has a project on its agenda, as the direct result of very troubling findings arising from its inspections of public companies. This project as instituted because auditors have been found to be lacking in independence, professional skep-

ticism and reasonable judgment. The project is in the early stages and a concept release seeking public comment has been released. Yet, at this very early stage Congress is proposing to step in and override the PCAOB, preventing it from adopting rules on mandatory rotation.

Audits are only worth paying for, if they are independent. A dozen years ago, the SEC rewrote the auditor independence rules. But these rules were watered down as a result of undue pressure from Congress as it bowed to the whims of the auditing profession lobby. That turned out to be a disastrous decision as Enron, WorldCom, Adelphia, Xerox and a host of other corporate scandals arose in which it appeared the auditors lacked independence.

Congress is now poised to make the same mistake, yet again. Instead, it should allow the process to run its normal course, obtain the comments from the public, conduct the 4 public hearings it has undertaken, and wait for the outcome of the deliberations.

The second concern with Section 5 is that it requires the SEC to perform a cost benefit analysis of each new rule the PCAOB promulgates. The legislation wording as currently crafted, puts a premium on the cost to the company rather than the benefit to investors and capital markets.

And I understand it, any cost benefit study would need to be completed within 60 days of the adoption of a new PCAOB rule. Often that is simply not possible, and so the legislation in essence would exempt emerging companies as defined from new PCAOB rules.

At a minimum, the language should be changed to balance any cost benefit analysis. The SEC should also be given a reasonable period of time to conduct such studies. In addition, while I was Chief Accountant, the industry refused to provide data useful to a cost benefit study. If the industry was once again to refuse to provide necessary data to the SEC or PCAOB, those agencies should be exempted from the cost benefit study requirement provided they can demonstrate any new rule would adequately protect investors and was in investors' best interests.

It is also worth noting that the restrictions that Congress proposes to place on the SEC, the PCAOB and the FASB apply to all companies defined as emerging companies. This would include for example, the population of Chinese companies that in recent years have become an emerging scandal in and of themselves. Investors have and continue to suffer losses in investments of such companies. One must ask, is it really good public policy to roll back regulations as proposed for such companies when the problems grow larger by the day.

I would urge the Committee to consider adding to this section of the legislation, the bi-partisan proposal by Senator Reed and Grassley that would enhance the transparency of the enforcement activities of the PCAOB. As the press and public have rightly pointed out, this would enhance the credibility of the agency and permit investors to understand whether there are serious questions about the quality of audits they are receiving from certain auditors.

Section 6 Availability of Information About Emerging Growth Companies

This is an ill-conceived and poorly thought out section of the bill. As a CFO, I watched as analysts engaged in "marketing" the underwriting of IPO's and public companies to investors. They were anything but independent and their research was misleading. They were in essence, an extension of sales and underwriting arms of the investment banking firms. This led to the Wall Street Analyst Scandal discussed further at Exhibit 5. It also resulted in investors being mislead and suffering significant losses on their investments.

Unfortunately this legislation legitimizes this type of behavior. And it fails to recognize the importance of independent research as well as meaningful disclosure of conflicts that do exist. Rather it establishes a process whereby analysts can once again engage in issuing conflicted reports and avoid accountability for their actions.

Below is a chart that reflects the type of reporting this legislation is likely to bring about. As noted, even after the dot com bubble had burst, and just before the largest corporate scandals in this country erupted, analysts were still touting stocks.

Chart 12

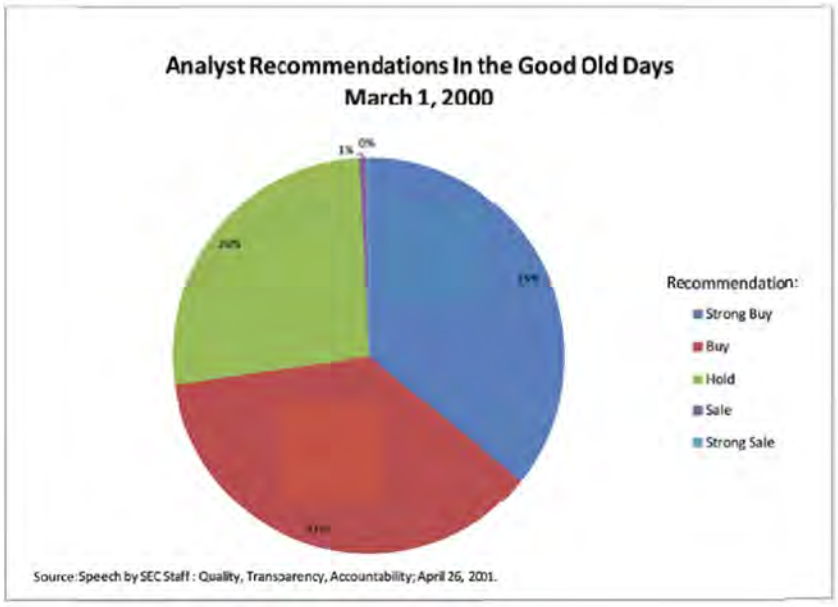
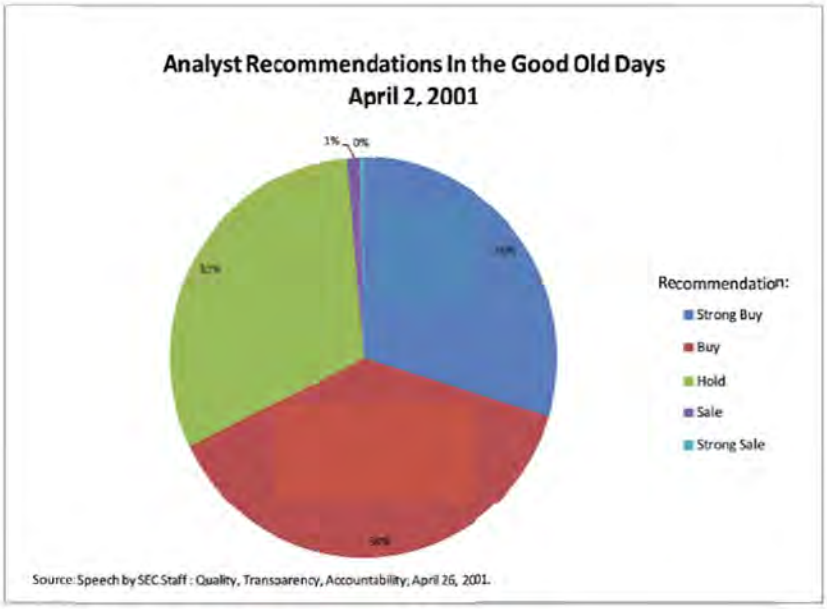


Chart 13



At a minimum, the legislation should adopt the investor protection measures encompassed in the well known Wall Street settlement. This includes provisions that ensure the analyst has to remain independent of the underwriting and investment

banking function, and that any conflicts are disclosed in a complete and transparent fashion.

With the Wall Street settlement requirements having lapsed, behavior among Wall Street analysts has quickly returned to what it was before the settlement. No one should be surprised if the outcome and history is repeated once again.

Other

The Administration has indicated, and the title of the hearing today would suggest, that the legislation should include investor protections. Currently Senate Bill 1933 and the other bills have fallen way short in this respect. Other commenters and people who have already testified have eloquently pointed that out. I hope the Committee will give due consideration to those points. For example, at Exhibit 6, the ICI has voiced its strong opposition to general solicitations noting they are not appropriate for the U.S. capital markets. At Exhibit 7, Professor Jay Brown has noted some reasoned changes that should be made. And at Exhibit 3, several organizations have made meaningful suggestions very worthy of consideration and acceptance.

In addition to those improvements to the legislation, I would add:

1. Private offerings, which in all likelihood will reduce rather than increase the number of IPO's, should be regulated. Currently, the SEC does not have the resources to engage in meaningful regulation. Accordingly, the State securities regulators should be permitted to regulate offerings and protect investors in their communities when the SEC is unable to.
2. Recent reports have highlighted the level of recidivism that has occurred on Wall Street and gone unchecked. I would urge the Committee to adopt stronger enforcement penalties that ratchet up as recidivism occurs. Penalties such as those included in SOX for auditors are much more appropriate today than existing penalties given changes in the markets.
3. Sanctions should be strengthened for both private and public offerings, when it is found a seller of securities has failed to undertake and ensure the suitability of a security for the investor, or has failed to conduct meaningful and necessary due diligence. All too often we have seen underwritings in which the investment bankers failed to ensure adequate disclosure of key risks and financial data. This is especially true when one relaxes rules governing solicitation.
4. The definition of an accredited investor should be changed. Tying this definition to wealth is inappropriate as we saw with many of the investors in recent Ponzi schemes, such as in the Madoff matter. The seller should be required to obtain a statement from the investor that they not only have a specified level of assets, but also have a reasonable working knowledge to permit them to appropriately analyze the intended investment. If the broker has knowledge that contradicts this, then the investor should not be accredited.

Summary

More jobs and a larger number of qualified IPO's is something we all strive for. But IPO's have to be successful for not only those selling stock, but also for those buying shares. This legislation is currently unbalanced and likely to result in more unsuccessful investments for investors. In the long run, history has judged clearly that such incidents serve to reduce IPO's, cost jobs, and cost investors money sorely needed for retirement and education.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM WILLIAM D. WADDILL

Q.1. What do you feel are the primary reasons for the decline in the number of initial public offerings for smaller companies? Do you foresee a return to the number of IPOs from the late 1990s?

A.1. Did not respond by publication deadline.

Q.2. In S. 1933, an "emerging growth company" would include companies with up to $1 billion in revenues. What are your views on whether this is the appropriate number and whether revenues is the appropriate metric to identify companies that should get reduced regulatory requirements?

A.2. Did not respond by publication deadline.

Q.3. What would be the effects of exempting an "emerging growth company" from having its auditor attest to the effectiveness of its internal financial controls on the company and on investors?

A.3. Did not respond by publication deadline.

Q.4. What types of companies would you expect to use crowdfunding to raise capital, instead of going to other sources of funds such as private equity fund, venture capital fund or banks? What types of investors do you expect to invest through crowdfunding?

A.4. Did not respond by publication deadline.

Q.5. Professor Ritter in his testimony identified the possibility that if a company is very successful, and has multiple rounds of financing, there is a possibility that "the small investors wind up exposed, being diluted out." Mr. Rowe stated that "it's a valid concern." How do you feel that this issue should be addressed for small investors in crowdfunding offerings?

A.5. Did not respond by publication deadline.

Q.6. Ms. Smith testified that "the transparency of our [IPO] markets are very poor, which hurts and scares a lot of investors in the markets." She suggested greater use of the SEC's EDGAR Onliner system to post transcripts of road shows or a red-lined copy of amended registration statements. Do you feel that the transparency of the IPO market could be enhanced in ways that would encourage more investors to invest in IPOs?

A.6. Did not respond by publication deadline.

Q.7. You testified that "For my company to try and prepare for Sarbanes-Oxley compliance will be somewhere between $3 million to $3.5 million." You later testified "from our company's point of view, when we look at the use of capital . . . do we want to spend $3 million ramping up into Sarbanes-Oxley compliance?" Costs are a relevant factor to this discussion. Please describe the types of

costs that you have identified for your company to comply with Sarbanes-Oxley that would total a cost of $3–$3.5 million.

A.7. Did not respond by publication deadline.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JAY R. RITTER

Q.1. What do you feel are the primary reasons for the decline in the number of initial public offerings for smaller companies? Do you foresee a return to the number of IPOs from the late 1990s?

A.1. I think that the primary reason for the decline in IPOs, especially small company IPOs, is a lack of investor enthusiasm due to low stock market returns, which in turn is due to the lack of profitability of most small companies after going public. From 1980–2009, 3,761 companies went public in the United States that had less than $50 million ($2009) in annual sales in the year before the IPO. From the closing market price on the first day until their 3-year anniversary, the average small company IPO had a 3-year buy-and-hold return of only 4.7 percent, and performance relative to the broader stock market of –35.7 percent. The small company IPOs from 1980–2000 were unprofitable (negative EPS) in 58 percent of their first three fiscal years after the IPO. This percentage has increased to 73 percent for the small company IPOs from 2001–2009.

I believe that the deteriorating profitability of small company IPOs is attributable to a long-term trend in many sectors of the global economy, especially in the technology industry, that is favoring big companies. Many sectors are now "winner takes all" markets, where getting big fast has become more important than it used to be. Small companies are accomplishing this by selling out to a bigger company, rather than staying independent. Thus, the issue is big vs. small, not public company vs. private company.

Q.2. In S. 1933, an "emerging growth company" would include companies with up to $1 billion in revenues. What are your views on whether this is the appropriate number and whether revenues is the appropriate metric to identify companies that should get reduced regulatory requirements?

A.2. I believe that revenue is an appropriate measure, although $1 billion may be too high.

Q.3. What would be the effects of exempting an "emerging growth company" from having its auditor attest to the effectiveness of its internal financial controls on the company and on investors?

A.3. I am in favor of dropping the auditor attestation requirement. A more effective way of deterring securities fraud is to penalize the people who commit the fraud.

Q.4. What types of companies would you expect to use crowdfunding to raise capital, instead of going to other sources of funds such as private equity fund, venture capital fund or banks? What types of investors do you expect to invest through crowdfunding?

A.4. I do not expect crowdfunding to be very successful. Venture capitalists provide both money and advice. I do not think that there

are a lot of great investment opportunities out there that will be identified and funded through crowdfunding.

Q.5. Professor Ritter, in your testimony you identified the possibility that if a company is very successful, and has multiple rounds of financing, there is a possibility that "the small investors wind up exposed, being diluted out." Mr. Rowe stated that "it's a valid concern." How do you feel that this issue should be addressed for small investors in crowdfunding offerings?

A.5. One possibility would be to have anti-dilution provisions as the default. It is very possible that private sector intermediaries will insist on this without Government requirements.

Q.6. Ms. Smith testified that "the transparency of our [IPO] markets are very poor, which hurts and scares a lot of investors in the markets." She suggested greater use of the SEC's EDGAR Online system to post transcripts of road shows or a red-lined copy of amended registration statements. Do you feel that the transparency of the IPO market could be enhanced in ways that would encourage more investors to invest in IPOs?

A.6. Her suggestion to flag changes in the S–1 s is a good idea. One issue that was not discussed is why investment banking fees (the gross spread) are much higher in the United States than in Europe. If a company sets an offer price of $10 per share and pays a gross spread of 7 percent, the company nets $9.30 if the stock trades at $11.00, the company has received $9.30 for shares worth $11.00, and this $1.70 cost (direct and indirect) is more than 15 percent of the $11 market price. If these costs were lowered, more companies would go public.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM KATHLEEN SHELTON SMITH

Q.1.a. What do you feel are the primary reasons for the decline in the number of initial public offerings for smaller companies?

A.1.a. While the global financial crisis in 2008 and 2011 reduced investor interest in stocks overall, as well as IPOs; it is the outsized losses that investors suffered from owning stocks of smaller newly public companies when the Internet bubble burst in 2000 that is the primary reason for the decline in the number of offerings for smaller companies. After the Internet bubble burst, many unprofitable and overvalued smaller newly public companies went out of business. Investors lost trust in this segment of the IPO market and in the underwriting firms that promoted these offerings.

Q.1.b. Do you foresee a return to the number of IPOs from the late 1990s?

A.1.b. The high IPO activity levels of the 1990s were above historical norms and the culmination of 20 years of strong stock market returns following the weak 1970s. However, we could foresee achieving above average IPO levels again, but only after investors experience a sustained period of positive stock market returns. As investor confidence returns, more capital will be allocated to equi-

ties and a rising number of smaller companies will be able to access the IPO market.

Q.2. In S. 1933, an "emerging growth company" would include companies with up to $1 billion in revenues. What are your views on whether this is the appropriate number and whether revenues is the appropriate metric to identify companies that should get reduced regulatory requirements?

A.2. We believe that revenue is not an appropriate metric to identify a company as an "emerging growth company". Differences in revenue recognition and profit margins among companies in different industries make revenue a poor measure to judge company size. We believe that market capitalization (a measure of company value) is the most appropriate metric to measure the size of a company.

We define an emerging growth company as one having a market capitalization below $250 million, a definition also used by the SEC (see attached). Our data shows that companies with less than $250 million in market capitalization typically offer IPOs of $50 million or less. It is these companies seeking to raise $50 million or less that have had difficulty accessing the public markets as shown by the IPO Task Force data.

Q.3. What would be the effects of exempting an "emerging growth company" from having its auditor attest to the effectiveness of its internal financial controls on the company and on investors?

A.3. Investors may be more cautious about investing in an emerging growth company that is exempt from the auditor test. This could result in a higher cost of capital for the company. However, for a smaller company (<$250 million in market capitalization), improved earnings from the savings of audit costs, may offset this higher cost of capital.

Q.4. What types of companies would you expect to use crowdfunding to raise capital, instead of going to other sources of funds such as private equity fund, venture capital fund or banks? What types of investors do you expect to invest through crowdfunding?

A.4. Crowdfunding will likely be used by weak businesses unable to access funding from knowledgeable investors/bankers. We would expect those who invest through crowd funding would be unsophisticated consumers.

Q.5. Professor Ritter in his testimony identified the possibility that if a company is very successful, and has multiple rounds of financing, there is a possibility that "the small investors wind up exposed, being diluted out." Mr. Rowe stated that "it's a valid concern." How do you feel that this issue should be addressed for small investors in crowdfunding offerings?

A.5. Anti-dilution provisions, tag along rights, board representation, convertible preferred structures favorable in bankruptcy, and many other protections are common in contracts used by knowledgeable private investors. While it may be difficult to replicate all these protections in a crowdfunding scenario, we recommend requiring participants (companies, intermediaries, platforms) in this market to comply with securities and consumer protection laws.

Q.6. Ms. Smith, you testified that "the transparency of our [IPO] markets are very poor, which hurts and scares a lot of investors in the markets." She suggested greater use of the SEC's EDGAR Online system to post transcripts of road shows or a red-lined copy of amended registration statements. Do you feel that the transparency of the IPO market could be enhanced in ways that would encourage more investors to invest in IPOs?

A.6. We believe that the transparency of the IPO market could be enhanced in two ways that would encourage more investors to invest in IPOs. One is more timely disclosure of the share ownership of newly public companies and the other is further modernization of corporate disclosure on EDGAR.

At present, the trading market for IPOs is highly volatile with average IPO trading turnover on the first day often equal to the number of shares offered. This suggests that IPO shares are being placed with short-term trading clients of the IPO underwriters. We believe that the IPO allocation process should be subject to SEC supervision. At the time an IPO is priced and prior to its trading, we recommend that underwriters file confidentially with the SEC the name of the account receiving an IPO allocation and the number of shares allotted and to disclose certain of this information publicly (as is done in Hong Kong). In aftermarket trading, to the extent an investor's share ownership exceeds 5 percent of the public float, we recommend that notice be made to the marketplace immediately (the standard 10-day notice is too long). IPO shares placed with a broader base of fundamentally oriented investors would help open the IPO market to smaller issuers and additional timely disclosure of share ownership would help calm the volatile trading market for newly public companies.

We recommend continuing to modernize corporate electronic disclosure through EDGAR to make it easier for investors to obtain and analyze information. We suggest showing red-lined amendments to registration statements and providing transcripts of company presentations. Efficient and open access to information about newly public companies is the best way to encourage an informed public viewpoint about new companies, which ultimately benefits smaller issuers.

SECURITIES AND EXCHANGE COMMISSION

Release Nos. 33-9258; 34-65322; File No. 265-27

SUBJECT: Advisory Committee on Small and Emerging Companies.

AGENCY: Securities and Exchange Commission.

ACTION: Notice of Federal Advisory Committee Establishment.

SUMMARY: The Securities and Exchange Commission intends to establish the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies.

ADDRESSES: Written comments may be submitted by the following methods:

Electronic Comments

- Use the Commission's Internet submission form (http://www.sec.gov/rules/other.shtml); or
- Send an e-mail message to rule-comments@sec.gov, including File No. 265-27 on the subject line.

Paper Comments

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. 265-27. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/other.shtml). Comments also will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business

days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from your submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Johanna V. Losert, Special Counsel, or Gerald J. Laporte, Office Chief, Office of Small Business Policy, Securities and Exchange Commission, 100 F Street, NE, Washington DC 20549-3628, (202) 551-3460.

SUPPLEMENTARY INFORMATION: In accordance with the requirements of the Federal Advisory Committee Act, 5 U.S.C. – App., the Commission is publishing this notice that the Chairman of the Commission, with the concurrence of the other Commissioners, intends to establish the Securities and Exchange Commission Advisory Committee on Small and Emerging Companies (the "Committee"). The Committee's objective is to provide the Commission with advice on its rules, regulations, and policies, with regard to its mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation, as they relate to the following:

(1) capital raising by emerging privately-held small businesses ("emerging companies") and publicly traded companies with less than $250 million in public market capitalization ("smaller public companies") through securities offerings, including private and limited offerings and initial and other public offerings;

(2) trading in the securities of emerging companies and smaller public companies; and

(3) public reporting and corporate governance requirements of emerging companies and smaller public companies.

Up to 20 voting members will be appointed to the Committee who can effectively represent those directly affected by, interested in, and/or qualified to provide advice to the Commission on its rules, regulations, and policies as set forth above. The Committee's membership will be balanced fairly in terms of points of view represented and functions to be performed. Non-voting observers for the committee from the North American Securities Administrators Association and the Small Business Administration may also be named.

The Committee may be established 15 days after publication of this notice in the *Federal Register* by filing a charter for the Committee with the Committee on Banking, Housing, and Urban Affairs of the United States Senate and the Committee on Financial Services of the United States House of Representatives. A copy of the charter as so filed also will be filed with the Chairman of the Commission, furnished to the Library of Congress, and posted on the Commission's website at www.sec.gov. An undated copy of the charter is now available at www.faca.gov.

The Committee will operate for two years from the date it is established or such earlier date as determined by the Commission unless, before the expiration of that time period, its charter is re-established or renewed in accordance with the Federal Advisory Committee Act.

The Committee will meet at such intervals as are necessary to carry out its functions. The charter contemplates that the full Committee will meet three times

annually. Meetings of subgroups or subcommittees of the full Committee may occur more frequently.

The charter will provide that the duties of the Committee are to be solely advisory. The Commission alone will make any determinations of action to be taken and policy to be expressed with respect to matters within the Commission's authority as to which the Committee provides advice or makes recommendations. The Chairman of the Commission affirms that the establishment of the Committee is necessary and in the public interest.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: September 12, 2011

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM TIMOTHY ROWE

Q.1. What do you feel are the primary reasons for the decline in the number of initial public offerings for smaller companies? Do you foresee a return to the number of IPOs from the late 1990s?

A.1. I am not an academic, but I can say anecdotally that I regularly hear smaller companies speak of the pain of being a public company. They focus in particular the time and distractions from the core business that the requirements of being public pose.

Q.2. In S. 1933, an "emerging growth company" would include companies with up to $1 billion in revenues. What are your views on whether this is the appropriate number and whether revenues is the appropriate metric to identify companies that should get reduced regulatory requirements?

A.2. I think the threshold should be set such that it accomplishes two goals: a) high enough that the new scaled regulations are available to most companies that might otherwise shy away from going public due to regulation, while b) not being so high as to include many companies that don't need this incentive. One billion ($1B) seems reasonable in this context.

Q.3. What would be the effects of exempting an "emerging growth company" from having its auditor attest to the effectiveness of its internal financial controls on the company and on investors?

A.3. In all things, there is a balance. In a costless environment, it would always be preferable to have more audits and more reviews. But every review implies a cost. I believe there is a logic that the smaller the company, the lower costs of regulation that we ought impose on them. If we do not make this choice sometimes, the engine of commerce will be impaired. I believe it is incumbent on regulators to measure the total cost to society of the regulation and compare it with the total cost to society of the losses incurred as a result of malfeasance. I have not seen such an analysis, but I would welcome it. It would shed light on this debate.

Q.4. What types of companies would you expect to use crowdfunding to raise capital, instead of going to other sources of funds such as private equity fund, venture capital fund or banks? What types of investors do you expect to invest through crowdfunding?

A.4. I'm as eager as all of us to see how this plays out. I'm hopeful that it will serve local businesses: a new catering business here, a plumbing business there, as well as innovation-driven businesses such as Gotham Bicycle Defense, that recently raised money for its theft-resistant bike lights on Kickstarter. If you look at examples from England, companies include, for example, a natural salad dressing provider, an organic soap manufacturer and a regional pro soccer team.

Q.5. Professor Ritter in his testimony identified the possibility that if a company is very successful, and has multiple rounds of financing, there is a possibility that "the small investors wind up exposed, being diluted out." Mr. Rowe, you stated that "it's a valid

concern." How do you feel that this issue should be addressed for small investors in crowdfunding offerings?

A.5. I'm pleased that the final legislation requires the use of intermediaries. I believe that in order to stay in business, crowdfunding intermediaries will naturally be driven to ensure that both sides of the transaction are taken care of. Investors must be protected by fair investment terms, and investees must have the flexibility to run their businesses. Fair terms are settled on every day in the venture investing world. It is a straightforward matter for the crowdfunding portal do develop a menu of "model" investing terms that it enforces. I don't believe at this time that it is necessary for Government to define these terms, as I believe the market will evolve the most balanced solutions on its own through the self-regulation structure embodied in the legislation.

Q.6. Ms. Smith testified that "the transparency of our [IPO] markets are very poor, which hurts and scares a lot of investors in the markets." She suggested greater use of the SEC's EDGAR Online system to post transcripts of road shows or a red-lined copy of amended registration statements. Do you feel that the transparency of the IPO market could be enhanced in ways that would encourage more investors to invest in IPOs?

A.6. Again, there is a balance in all things. Transparency is good, but it comes at a cost, both in time to prepare, limitations on what can be shared spontaneously, and in terms of exposure of private commercial information to competitors. I don't consider myself the expert that Ms. Smith is in these matters. I would simply caution that "more transparency" is not universally always useful: we need to strike an appropriate tradeoff here. One exception is that were information is already required to be publicly available, I strongly agree that it should be made available in an easy-to-access manner, such as providing it to EDGAR.

Q.7. Mr. Rowe, you testified that "in my experience sitting on boards in the venture capital context, we see . . . over and over again the companies that are acquired very frequently end up dying. The buying company may pay a high price, but they do not really have the spirit or the passion that the entrepreneur has." Please provide additional information on your experiences and how these acquired companies died and, to the extent of your knowledge, the impact on jobs.

A.7. Here is an excellent article in the popular press on the subject: *http://www.xconomy.com/san-francisco/2012/03/05/googles-rules-ofacquisition-how-to-be-an-android-not-an-aardvark/*

Quoting from the article:

> Acquisitions so often go awry that it's a wonder big corporations keep shelling out to buy smaller ones at all. I believe this would be a valuable area for academic research. Anecdotally, most observers of venture capital would agree that companies that go public are far more likely to succeed than companies that are acquired.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM LYNN E. TURNER

Q.1. What do you feel are the primary reasons for the decline in the number of initial public offerings for smaller companies? Do you foresee a return to the number of IPOs from the late 1990s?

A.1. Did not respond by publication deadline.

Q.2. In S. 1933, an "emerging growth company" would include companies with up to $1 billion in revenues. What are your views on whether this is the appropriate number and whether revenues is the appropriate metric to identify companies that should get reduced regulatory requirements?

A.2. Did not respond by publication deadline.

Q.3. What would be the effects of exempting an "emerging growth company" from having its auditor attest to the effectiveness of its internal financial controls on the company and on investors?

A.3. Did not respond by publication deadline.

Q.4. What types of companies would you expect to use crowdfunding to raise capital, instead of going to other sources of funds such as private equity fund, venture capital fund or banks? What types of investors do you expect to invest through crowdfunding?

A.4. Did not respond by publication deadline.

Q.5. Professor Ritter in his testimony identified the possibility that if a company is very successful, and has multiple rounds of financing, there is a possibility that "the small investors wind up exposed, being diluted out." Mr. Rowe stated that "it's a valid concern." How do you feel that this issue should be addressed for small investors in crowdfunding offerings?

A.5. Did not respond by publication deadline.

Q.6. Ms. Smith testified that "the transparency of our [IPO] markets are very poor, which hurts and scares a lot of investors in the markets." She suggested greater use of the SEC's EDGAR Online system to post transcripts of road shows or a red-lined copy of amended registration statements. Do you feel that the transparency of the IPO market could be enhanced in ways that would encourage more investors to invest in IPOs?

A.6. Did not respond by publication deadline.

Additional Material Supplied for the Record

EXHIBIT 1

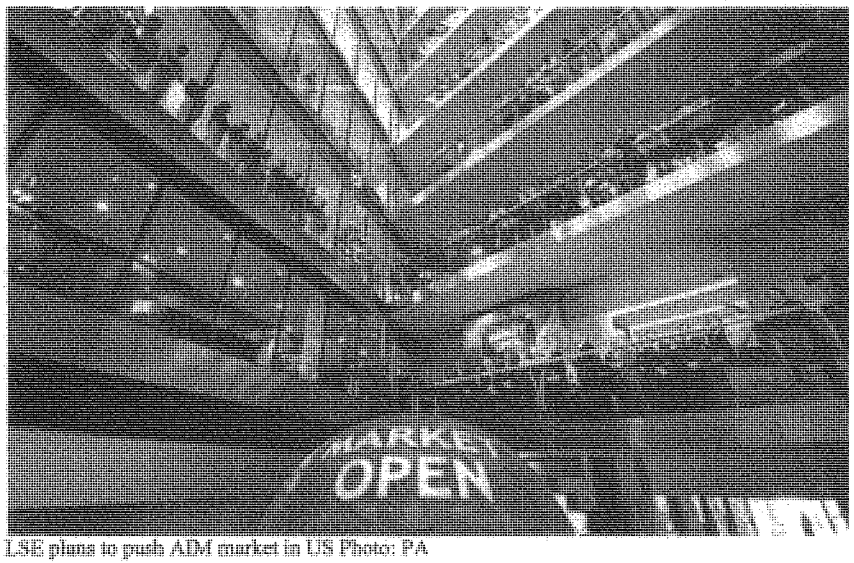
Investors Lack Confidence in AIM Market

From: http://www.telegraph.co.uk/

The Telegraph

LSE plans to push AIM market in US

The London Stock Exchange is exploring ambitious plans to push its junior AIM market into the United States once it completes its C$3.2bn (£1.9bn) takeover of TMX Group, owner of the Toronto Stock Exchange (TSX).



LSE plans to push AIM market in US Photo: PA

By Jamie Dunkley

9:00PM BST 05 Jun 2011

The LSE, which hopes to complete a takeover of the TSX owner later this year, will use the deal to increase the market share of AIM in the United States, where smaller companies have typically used private equity firms or banks to fund short-term lending.

TMX already operates the TSXVentures market, which focuses on smaller cap enterprises.

A merger of the two units remains unlikely, however sources close to the company said it was now looking at ways in which small and medium-sized companies in the US and Canada could list on AIM and eventually move on to the main market.

Although the plans remain at an early stage, they are likely to prove controversial given the attitude of the US regulators towards the AIM market in the past.

In 2007, Roel Campos, a commissioner at the Securities and Exchange Commission voiced his concerns that 30pc of new firms listing on AIM "are gone in a year".

Recent research for *The Daily Telegraph* has also shown that at least 80 leading money managers do not have confidence in the current regulation of natural resource companies on AIM.

EXHIBIT 2

Dot Com Flops Cost Investors and Jobs

c/net

From: http://www.cnet.com/1990-11136_1-6278387-1.html

THE POWER OF 10 The past, present, and future of digital life

Top 10 dot-com flops

By Kent German

The most astounding thing about the dot-com boom was the obscene amount of money spent. Zealous venture capitalists fell over themselves to invest millions in start-ups; dot-coms blew millions on spectacular marketing campaigns; new college graduates became instant millionaires and rushed out to spend it; and companies with unproven business models executed massive IPOs with sky-high stock prices. We all know what eventually happened. Most of hese start-ups died dramatic deaths. These are the celebrity victims of the new-economy bust.
http://www.cnet.com/1990-11136_1-6278387-1.html

Webvan (1999-2001)

A core lesson from the dot-com boom is that even if you have a good idea, it's best not to grow too fast too soon. But online grocer Webvan was the poster child for doing just that, making the celebrated company our number one dot-com flop. In a mere 18 months, it raised $375 million in an IPO, expanded from the San Francisco Bay Area to eight U.S. cities, and built a gigantic infrastructure from the ground up (including a *$1 billion* order for a group of high-tech warehouses). Webvan came to be worth $1.2 billion (or $30 per share at its peak), and it touted a 26-city expansion plan. But considering that the grocery business has razor-thin margins to begin with, it was never able to attract enough customers to justify its spending spree. The company closed in July 2001, putting 2,000 out of work and leaving San Francisco's new ballpark with a Webvan cup holder at every seat.

2 Pets.com (1998-2000)

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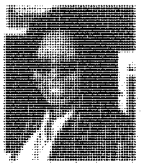
Another important dot-com lesson was that advertising, no matter how clever, cannot save you. Take online pet-supply store Pets.com. Its talking sock puppet mascot became so popular that it appeared in a multimillion-dollar Super Bowl commercial and as a balloon in the Macy's Thanksgiving Day Parade. But as cute--or possibly annoying--as the sock puppet was, Pets.com was never able to give pet owners a compelling reason to buy supplies online. After they ordered kitty litter, a customer had to wait a few days to actually get it. And let's face it, when you need kitty litter, you *need* kitty litter. Moreover, because the company had to undercharge for shipping costs to attract customers, it actually lost money on most of the items it sold. Amazon.com-backed Pets.com raised $82.5 million in an IPO in February 2000 before collapsing nine months later.

3 Kozmo.com (1998-2001)

The shining example of a good idea gone bad, online store and delivery service Kozmo.com made it on our list of the top 10 tech we miss. For urbanites, Kozmo.com was cool and convenient. You could order a wide variety of products, from movies to snack food, and get them delivered to your door for free within an hour. It was the perfect antidote to a rainy night, but Kozmo learned too late that its primary attraction of free delivery was also its undoing. After expanding to seven cities, it was clear that it cost too much to deliver a DVD and a pack of gum. Kozmo eventually initiated a $10 minimum charge, but that didn't stop it

from closing in March 2001 and laying off 1,100 employees. Though it never had an IPO (one was planned), Kozmo raised about $280 million and even secured a $150 million promotion deal with Starbucks.

4 Flooz.com (1998-2001)



For every good dot-com idea, there are a handful of really terrible ideas. Flooz.com was a perfect example of a "what the heck were they thinking?" business. Pushed by *Jumping Jack Flash* star and perennial *Hollywood Squares* center square Whoopi Goldberg, Flooz was meant to be online currency that would serve as an alternative to credit cards. After buying a certain amount of Flooz, you could then use it at a number of retail partners. While the concept is similar to a merchant's gift card, at least gift cards are tangible items that are backed by the merchant and not a third party. It boggles the mind why anyone would rather use an "online currency" than an actual credit card, but that didn't stop Flooz from raising a staggering $35 million from investors and signing up retail giants such as Tower Records, Barnes & Noble, and Restoration Hardware. Flooz went bankrupt in August 2001 along with its competitor Beenz.com.

5 eToys.com (1997-2001)

eToys is now back in business, yet its original incarnation is another classic boom-to-bust story.

[redacted] Much like Pets.com, eToys spent millions on advertising, marketing, and technology and battled a host of competitors. And like many of its failed brethren, all that spending outweighed the company's income, and investors quickly jumped ship. eToys closed in March 2001, but after being owned for a period by KayBee Toys, it's now back for a second run.

6 Boo.com (1998-2000)

boo.com

Though Boo.com is another flop that has been given new life by Fashionmall.com, its original incarnation proved that dot-com flops were not restricted to U.S. shores. Founded in the United Kingdom as an online fashion store, Boo.com was beset with problems and mismanagement from the start. Its complicated Web site, which relied heavily on JavaScript and Flash, was very slow to load at a time when dial-up Internet usage was the norm. Boo spent wads of cash to market itself as a global company but then had to deal with different languages, pricing, and tax structures in all the countries it served. The company also mysteriously decided to pay postage on returns, but even more importantly, sales never reached expectations. Boo.com eventually burned through $160 million before liquidation in May 2000.

7 MVP.com (1999-2000)

Like Planet Hollywood and Flooz.com, MVP.com proved that celebrity endorsements are worth nothing in the long run. Backed by sports greats John Elway, Michael Jordan, and Wayne Gretzky and $65 million, MVP sold sporting goods online. Founded in 1999, the company grew to more than 150 employees, but a high-profile partnership came to be a liability. A few months after its launch, MVP.com entered into an $85 million, four-year agreement with CBS in which the network would provide advertising in exchange for an equity stake in the e-tailer. Yet barely a year later, CBS and its online affiliate SportsLine.com killed the agreement because MVP.com failed to pay the network an agreed-upon $10 million per year. The game was over for MVP.com soon afterward, and SportsLine took over the domain.

8 Go.com (1998-2001)

The Walt Disney Company felt the sting of the dot-com bust with its portal Go.com. Started in 1998, Go.com was a combination of Disney's online properties and Infoseek, in which the Mouse had previously acquired a controlling interest. Though it was meant to be a "destination site" much like Yahoo, Go.com had its own little quirks, such as content restrictions against adult material. Disney was never able to make Go.com popular enough to validate the millions spent on

promotion. In January 2001, Go.com was shut down, and Disney took a write-off of $790 million. Go.com still exists, but it carries only feeds from other Disney Web properties.

9 Kibu.com (1999-2000)

Unlike the other flops listed here, Kibu.com, an online community for teenage girls, didn't wait till the very end to wave the white flag. In fact, at the time of its October 2000 closing, the company had not run out of the $22 million it raised. And on a more bizarre note, the end came only 46 days after a flashy San Francisco launch party. Though Kibu had started to attract traffic from its target demographic (incidentally one of the fastest-growing segments of Web users), company officials said they decided to shut down because "Kibu's timing in financial markets could not have been worse." Kibu was backed by several Silicon Valley bigwigs, and they sent a strong message about the financial prospects of other dot-coms by bailing on Kibu so soon.

10 GovWorks.com (1999-2000)

Last but certainly not least, the story of GovWorks.com was good enough to become the documentary Startup.com, which chronicles its brief life. Envisioned as a Web site for citizens to do business with municipal government, GovWorks was started by two childhood friends in 1999. One was the flashy salesman, while the other had the technical know-how. At first, the future seemed bright as they suddenly found themselves worth millions of dollars each and rubbing elbows with the politically powerful. But you can guess what happened--everything that could go wrong soon did. Personalities and egos clashed during long work hours, one partner was ousted, technology was stolen, and they never got the software to work as it should have. A competitor eventually took over GovWorks in 2000.

EXHIBIT 3

Investor and Consumer Recommendations

And

Opposition to Legislation

March 5, 2012

The Honorable Timothy Johnson
Chairman, Committee on Banking,
Housing and Urban Affairs
United Stated Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member, Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Johnson and Senator Shelby,

We are writing as representatives of consumers and investors throughout the nation to express our strong opposition to a package of "capital formation" bills that is being rushed through the House based on exaggerated claims of the bills' potential to create jobs and with no attention to their potential harmful effect on investor protections and market integrity. While we are strong supporters of measures to promote job growth, these bills (recently repackaged as the JOBS Act) are premised on the dangerous and discredited notion that the way to create jobs is to weaken regulatory protections. Each of these bills would in its own way roll back regulations that are essential to protecting investors from fraud and abuse, promoting the transparency on which well-functioning markets depend, and ensuring the fair and efficient allocation of capital. Moreover, they ignore the basic free market principle, backed by extensive research, that investors respond to reduced regulatory protections by imposing a higher cost of capital. Because they are likely to result in higher capital costs that negate any compliance cost savings, these bills don't even offer any prospect of meaningful job creation to justify their attack on fundamental investor and market protections.

We understand these bills are likely to be taken up soon in the Senate. We are writing to urge the Senate to take a more thoughtful and balanced approach than was adopted in the House. Where the House has gone after regulatory protections with a hatchet, we urge the Senate to use a scalpel, carefully targeting provisions that may be undermining capital formation without destroying essential investor protections in the process. Such an approach would not only better protect investors from a recurrence of the scandals, frauds, and crises that have devastated the markets over the past decade, it would also be more likely to produce sustainable job growth.

Toward that end, we offer the following specific comments on each of the major bills included in the House "capital formation" package. As our discussion should make clear, in all but a few cases, extensive revisions would be needed to arrive at an appropriately balanced approach.

IPO On-Ramp (H.R. 3606, S. 1933)

For decades our regulations have maintained that the privilege of raising money from average, unsophisticated retail investors should come only when companies are prepared to meet their responsibilities to provide those investors with accurate and reliable financial information and to adopt appropriate corporate governance practices. Doing away with that basic standard, H.R. 3606 and S. 1933, its companion measure in the Senate, seek to make it easier for companies to go public *before* they are prepared to meet those responsibilities. They do so by phasing in key investor protections over a period of up to five years after a company first goes public. The result would be a two-tier system on our public markets that would be enormously confusing for investors to navigate, would open the door to accounting fraud for less scrupulous market entrants, and would actually increase long-run costs for well-intentioned companies. For this reason alone, these bills should be defeated. The bills also include these additional specific flaws.

- Although the legislation is presented as benefiting "emerging" companies, it defines emerging companies to include all but the biggest behemoths among new companies. By using $1 billion in annual gross revenues and $700 million in market float as the basis for the definition of an "emerging" company, the bill ensures that even very large, well established companies that could easily afford compliance would be given a pass on meeting the basic responsibilities that go with being a public company.

- Among the investor protections that would be delayed are requirements that no reasonable person would argue create a barrier to capital formation, including requirements to disclose executive compensation, to require shareholder votes on golden parachutes, and to require periodic say-on-pay votes. This suggests that the legislation has less to do with eliminating barriers to capital formation than with eliminating requirements the business community finds inconvenient or uncomfortable.

- The bills would also undermine market transparency and increase audit complexity by delaying implementation of new accounting standards and new auditing standards for "emerging" companies. As a result, investors would have to try to compare financial statements from competing companies prepared using different accounting standards, and accounting firms would have to train their employees to conduct their audits using different auditing standards depending on whether the company is an "emerging" or established company. Again this change is proposed without any evidence that compliance with new accounting and auditing standards imposes a significant cost burden on new companies.

- Most troubling, the bill would roll back investor protections adopted in the wake of massive and widespread analyst and accounting scandals. The predictable result would be a resurgence of the frauds these protections were adopted to address. Moreover, the provision delaying implementation of SOX 404(b) would actually institutionalize one of the factors that contributed to the initial high costs of implementation – that it is much more difficult and costly to retrofit 404(b)-compliant controls onto an existing financial reporting system than to build them in from the outset. The increased material weakness

reports and financial restatements that would inevitably occur when the internal control audit was finally implemented after the phase-in period would cause significant avoidable losses for shareholders and a drop in investor confidence in the reliability of "emerging" companies' financial reporting.

In short, every provision of H.R. 3606 and S. 1933 is both unwarranted and misguided. It should not be included in any Senate "capital formation" package.

Crowd-funding (H.R. 2930, S. 1970, S. 1791)

Even the best of the crowd-funding bills would make it possible for the least sophisticated of investors to risk their limited funds investing in the most speculative of small companies. These investments would be made without the opportunity for extensive due diligence that venture capital funds and angel investors engage in before making comparable investments. At best, therefore, even if Congress does everything right in terms of imposing appropriate investor protections, most of those who invest through crowd-funding sites are likely to lose some or all of their money. At worst, crowd-funding web sites could become the new turbo-charged pump-and-dump boiler room operations of the internet age. Meanwhile, money that could have been invested in small companies with a real potential for growth would be syphoned off into these financially shakier, more speculative ventures. The net effect would likely be to undermine rather than support sustainable job growth. For that reason, we question the wisdom of adopting any of the proposed crowd-funding bills.

Among the various bills, however, S. 1970 stands out as a serious and responsible effort to ensure that crowd-funding sites are appropriately regulated. In particular, we support S. 1970's inclusion of an aggregate cap on investments, its requirement that crowd-funding sites be registered with and subject to regulatory oversight by the SEC, its more robust requirements regarding the duties of those intermediaries to prevent fraud, its prohibition against active solicitation by sites that are not registered as a broker-dealer, and its preservation of state authority. If Congress insists on moving forward with this legislation, therefore, it should at least adopt the more robust investor protections in S. 1970 to minimize the extent of harm that results to unwary investors and to maximize the potential that investments through these sites go to support legitimate businesses.

Regulation D Revisions (H.R. 2940, S. 1831)

Private offerings under Regulation D are flourishing, with roughly $900 billion raised through such offerings in 2010 alone and an estimated 20,000 to 30,000 such offerings issued each year in recent years. At the same time, Reg D offerings have become a source of significant market abuses, as documented by the North American Securities Administrators Association. This legislation would greatly increase the risks associated with these offerings by eliminating restrictions on general solicitation of investors. Supporters of the legislation argue that the limitation on general solicitation is not needed, since the offerings are sold exclusively to accredited investors. But neither the $200,000-$300,000 in income standard for accredited investors nor the $1 million in net worth requirement is a guarantee of financial sophistication or an ability to withstand losses. For example, a retiree who has accumulated $1 million over a

lifetime of saving, and who depends on that money for income in retirement, would be a particularly poor candidate for investment in a private offering. But, if limitations on general solicitation were eliminated, such individuals would soon be flooded with such "opportunities." Moreover, neither of these bills as drafted limits itself to offerings sold exclusively to accredited investors.

While the rules regarding general solicitation may indeed merit review, this legislation represents a radical redrawing of the lines between public and private markets and should not be rushed into without greater attention to the potential risks of such an approach. We urge you, therefore, to conduct further study in order to determine whether legislation is needed and, if so, to adopt a much more narrowly targeted approach.

Shareholder Thresholds (H.R. 2167, H.R. 1965, S. 1824)

These bills would make it possible for companies, including very large companies with a large number of shareholders, to avoid making the periodic disclosures on which market transparency depends. The various bills would do this by simultaneously raising the limit on the number of shareholders of record who can hold a stock without triggering reporting requirements and exempting employees who hold company stock from the count. In addition, they would allow banks and bank holding companies to "go dark" if the number of shareholders of record dropped below 1,200, a move that would likely have a very negative affect on the value of investor holdings. Moreover, the bills would do all this without addressing the outdated and easily manipulated reliance on "shareholders of record" in making this determination.

Given the justifications that are offered for this legislation, it is unclear why both elimination of employees from the count and an increase in the shareholder threshold is needed. One or the other would seem to be adequate to address the stated concerns. At the very least, if you include broad shareholder threshold relief in a package of capital formation bills, we urge you to use a measure that is less subject to manipulation, such as beneficial owner, in determining the reporting threshold.

Regulation A Revisions (H.R. 1070, S. 1544)

These bills would increase from $5 million to $50 million the amount of capital that companies could raise from the public without triggering the full reporting and other obligations that go with registration. It is unclear whether the primary effect of this change would be to increase the number of small companies that choose to go public, with potential benefits for job creation, or to encourage companies that would otherwise have gone public to raise capital using the less transparent Reg A approach, with no similar beneficial effects and a potential to increase the cost of capital for such companies. Thus, this issue deserves a careful, balanced approach completely absent from the House bill.

While we cannot support either bill in its current form, we do appreciate that the sponsors of the Senate bill have made a good faith effort to balance easier access to capital with

appropriate investor protections, including up-front disclosures, periodic reporting, audited financial statements, SEC oversight, and a negligence-based litigation remedy. While the House bill is completely unacceptable, a relatively few revisions to S. 1544 would address our remaining concerns. Specifically, we urge you to impose a cumulative, multi-year cap on use of the Regulation A exemption, to minimize pressure on the SEC to further increase the ceiling and to limit the amount that the SEC could raise the ceiling in the future, and to impose a strict liability standard to better ensure accurate disclosures in this loosely regulated market. Taken together, these changes would minimize the potential for investor harm while still significantly expanding access to Regulation A offerings.

* * *

Millions of Americans continue to suffer the consequences of a financial crisis brought about by weak and ineffective financial regulation. They deserve better from Congress and this Administration than dangerous deregulatory "capital formation" proposals masquerading as job creation policy. We urge you to reject the many anti-investor proposals included in this so-called jobs creation package and to adopt instead a narrowly targeted, balanced approach that preserves regulatory requirements vital to the protection of investors, the promotion of market transparency, and the preservation of fair and efficient allocation of capital.

Sincerely,

AFSCME
Americans for Financial Reform
Chicago Consumer Coalition
Consumer Action
Consumer Federation of America
Consumer Federation of California
Consumer Federation of the Southeast
Empowering and Strengthening Ohio's People (ESOP)
Florida Consumer Action Network
Main Street Alliance
Massachusetts Communities Action Network
National Association of Consumer Advocates (NACA)
National Consumers League
National Education Association
NEDAP
ProgressOhio
Public Citizen
SAFER: The Economists' Committee for Stable, Accountable, Fair, and Efficient Financial Reform
U.S. PIRG
Virginia Citizens Consumer Council
Will Will Win, Inc.

Cc: Members, United States Senate

Via Hand Delivery

March 1, 2012

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

As a nonprofit, nonpartisan association of public, corporate and union pension plans, and other employee benefit funds, foundations and endowments with combined assets that exceed $3 trillion, the Council of Institutional Investors (Council) is committed to protecting the retirement savings of millions of American workers.[1] With that commitment in mind, and in anticipation of your upcoming March 6 hearing entitled "Spurring Job Growth Through Capital Formation While Protecting Investors, Part II," we would like to share with you some of our concerns and questions about S. 1933, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011."

Our questions and concerns about S. 1933 are grounded in the Council's membership approved corporate governance best practices.[2] Those policies explicitly reflect our members' view that *all* companies, including "companies in the process of going public should practice good corporate governance."[3] Thus, we respectfully request that the Committee consider changes to, or removal of, the following provisions of S. 1933:

Definitions

We question the appropriateness of the qualities defining the term "emerging growth company" (EGC) as set forth in Sec. 2(a) and 2(b).

[1] For more information about the Council of Institutional Investors (Council) and our members, please see our website at www.cii.org.
[2] Council of Institutional Investors, Corporate Governance Policies (Last updated Dec. 21, 2011) [hereinafter Policies] http://www.cii.org/UserFiles/file/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL%20(2).pdf.
[3] *Id.* § 1.7 Governance Practices at Public and Private Companies.

As you are aware, under Sec. 2(a) and 2(b) a company would qualify for special status for up to five years, so long as it has less than $1 billion in annual revenues and not more than $700 million in public float following its initial public offering (IPO). The Council is concerned that those thresholds may be too high in establishing an appropriate balance between facilitating capital formation and protecting investors.

For example, we note that some of the most knowledgeable and active advocates for small business capital formation have in the past agreed that a company with more than $250 million of public float generally has the resources and infrastructure to comply with existing U.S. securities regulations.[4] We, therefore, urge the Committee to reevaluate the basis for the proposed thresholds defining an EGC.

Disclosure Obligations

We have concerns about Sec. 3(a)(1) because it would effectively limit shareowners' ability to voice their concerns about executive compensation practices.

More specifically, Sec. 3(a)(1) would revoke the right of shareowners, as owners of an EGC, to express their opinion collectively on the appropriateness of executive pay packages and severance agreements.

The Council's longstanding policy on advisory shareowner votes on executive compensation calls on all companies to "provide annually for advisory shareowner votes on the compensation of senior executives."[5] The Investors Working Group echoed the Council's position in its July 2009 report entitled *U.S. Financial Regulatory Reform: The Investors' Perspective*.[6]

Advisory shareowner votes on executive compensation and golden parachutes efficiently and effectively encourage dialogue between boards and shareowners about pay concerns and support a culture of performance, transparency and accountability in executive compensation. Moreover, compensation committees looking to actively rein in executive compensation can utilize the results of advisory shareowner votes to defend against excessively demanding officers or compensation consultants.

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[4] *See* 2010 Annual SEC Government-Business Forum on Small Business Capital Formation Final Report 18 (June 2011), http://www.sec.gov/info/smallbus/gbfor29.pdf (citing recommendation to "[i]ncrease the amount of public float in the definition of 'smaller reporting company' from $75 million to $250 million" as a high priority).

[5] Policies, *supra* note 2, § 5.2 Advisory Shareowner Votes on Executive Pay.

[6] Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 23 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf. Following its issuance, the Investors' Working Group (IWG) Report was reviewed and subsequently endorsed by the Council board and membership. For more information about the IWG, please visit the Council's website at http://www.cii.org/iwgInfo.

The 2011 proxy season has demonstrated the benefits of nonbinding shareowner votes on pay. As described in *Say on Pay: Identifying Investors Concerns*:

> Compensation committees and boards have become much more thoughtful about their executive pay programs and pay decisions. Companies and boards in particular are articulating the rationale for these decisions much better than in the past. Some of the most egregious practices have already waned considerably, and may even disappear entirely.[7]

As the Committee deliberates the appropriateness of disenfranchising certain shareowners from the right to express their views on a company's executive compensation package, we respectfully request that the following factors be considered:

1. Companies are not required to change their executive compensation programs in response to the outcome of a say on pay or golden parachutes vote. Securities and Exchange Commission (SEC) rules simply require that companies discuss how the vote results affected their executive compensation decisions.

2. The SEC approved a two-year deferral for the say on pay rule for smaller U.S. companies. As a result, companies with less than $75 million in market capitalization do not have to comply with the rule until 2013, thus the rule's impact on IPO activity is presumably unknown. We, therefore, question whether there is a basis for the claim by some that advisory votes on pay and golden parachutes are an impediment to capital formation or job creation.

We also have concerns about Sec. 3(a)(2) because it would potentially reduce the ability of investors to evaluate the appropriateness of executive compensation.

More specifically, Sec. 3(a)(2) would exempt an EGC from Sec. 14(i) of the Securities Exchange Act of 1934, which would require a company to include in its proxy statement information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

We note that the SEC has yet to issue proposed rules relating to the disclosure of pay versus performance required by Sec. 14(i). As a result, no public companies are currently required to provide the disclosure. We, therefore, again question whether a disclosure that has not yet even been proposed for public comment is impeding capital formation or job creation.[8]

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[7] Robin Ferracone & Dayna Harris, *Say on Pay: Identifying Investor Concerns* 21 (Sept. 2011), http://www.cii.org/UserFiles/file/resource%20center/publications/Say%20On%20Pay%20-%20Identifying%20Investor%20Concerns.pdf.

[8] Similarly, Sec. 3(a)(3) of S. 1933 would exempt emerging growth companies from the disclosure of the ratio of CEO to median employee compensation required by Section 953(b)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, notwithstanding that the Securities and Exchange Commission has yet to even issue a proposal for public comment relating to that disclosure. While the Council does not have a position on this specific disclosure, § 5.1 of the Council's policies state: "It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as . . . *compensation paid to other employees*" (emphasis added).

Our membership approved policies emphasize that executive compensation is one of the most critical and visible aspects of a company's governance. Executive pay decisions are one of the most direct ways for shareowners to assess the performance of the board and the compensation committee.[9]

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term.[10] It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance.[11]

Transparency of executive compensation is a primary concern of Council members.[12] All aspects of executive compensation, including all information necessary for shareowners to understand how and how much executives are paid should be clearly, comprehensively and promptly disclosed in plain English in the annual proxy statement.[13]

Transparency of executive pay enables shareowners to evaluate the performance of the compensation committee and the board in setting executive pay, to assess pay-for-performance links and to optimize their role in overseeing executive compensation through such means as proxy voting.[14] It is, after all, shareowners, not executives, whose money is at risk.[15]

Accounting and Auditing Standards

We have concerns about Sec. 3(c) and Sec. 5 because those provisions would effectively impair the independence of private sector accounting and auditing standard setting, respectively.

More specifically, Sec. 3(c) would prohibit the independent private sector Financial Accounting Standards Board from exercising their own expert judgment, after a thorough public due process in which the views of investors and other interested parties are solicited and carefully considered, in determining the appropriate effective date for new or revised accounting standards applicable to EGCs.

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[9] Policies, *supra* note 2, § 5.1 Introduction.
[10] *Id.*
[11] *Id.*
[12] *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 14 (full text July 29, 2009) (statement of Ann Yerger, Executive Director, Council of Institutional Investors) [hereinafter Yerger] http://www.cii.org/UserFiles/file/testimony/07-29-09%20Ann%20Testimony%20FINAL%20(with%20all%20attachments).pdf.
[13] Policies, *supra* note 2, § 5.5h Disclosure Practices.
[14] Yerger, *supra* note 12, at 14.
[15] Policies, *supra* note 2, § 5.1 Introduction.

Similarly, Sec. 5 would prohibit the independent private sector Public Company Accounting Oversight Board from exercising their own expert judgment, after a thorough public due process in which the view of investors and other interested parties are solicited and carefully considered, in determining improvements to certain standards applicable to the audits of EGCs.[16]

The Council's membership "has consistently supported the view that the responsibility to promulgate accounting and auditing standards should reside with independent private sector organizations."[17] Thus, the Council opposes legislative provisions like Sec. 3(a) and Sec. 5 that override or unduly interfere with the technical decisions and judgments (including the timing of the implementation of standards) of private sector standard setters.[18]

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[16] One of the potential improvements to auditing standards referenced in Sec. 5 is "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) . . . ." We note that the Public Company Accounting Oversight Board has not yet issued a proposed rule relating to this topic. We also note that the Council, and many other investors, generally support improvements to the auditor's report that this provision would effectively defer for emerging growth companies. Letter from Jeff Mahoney to Office of the Secretary 3 (Sept. 19, 2011), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/September%2019%202011%20Letter%20to%20PCAOB.pdf.

[17] Council of Institutional Investors, Statement on Independence of Accounting and Auditing Standard Setters 1 (Adopted Oct. 7, 2008) [hereinafter Statement of Independence], http://www.cii.org/UserFiles/file/Statement%20on%20Independence%20of%20Accounting%20and%20Auditing%20Standard%20Setters.pdf.

[18] *See, e.g.*, Letter from Jeff Mahoney et el. to The Honorable Harry Reid et al. (May 7, 2010) [Joint Letter], http://www.thecaq.org/publicpolicy/pdfs/20100507StandardsetterindependencelettertoSenate.pdf (opposing "Brown amendment SA 3853 regarding 'Financial Reporting'" to the Restoring American Financial Stability Act of 2010 because of its impact on the independence of accounting standard setting); *cf.* Statement of Independence, *supra* note 17, at 2 (indicating that "technical decisions and judgments []including the timing of the implementation of standards[] [should be protected] from being overridden by government officials or bodies").

A 2010 joint letter by the Council, the American Institute of Certified Public Accountants, the Center for Audit Quality, the CFA Institute, the Financial Executives International, the Investment Company Institute, and the U.S. Chamber of Commerce[19] explains, in part, the basis for the Council's strong support for the independence of private sector standard setters:

> We believe that interim and annual audited financial statements provide investors and companies with information that is vital to making investment and business decisions. The accounting standards underlying such financial statements derive their legitimacy from the confidence that they are established, interpreted and, when necessary, modified based on independent, objective considerations that focus on the needs and demands of investors – the primary users of financial statements. We believe that in order for investors, businesses and other users to maintain this confidence, the process by which accounting standards are developed must be free – both in fact and appearance – of outside influences that inappropriately benefit any particular participant or group of participants in the financial reporting system to the detriment of investors, business and the capital markets. We believe political influences that dictate one particular outcome for an accounting standard without the benefit of public due process that considers the views of investors and other stakeholders would have adverse impacts on investor confidence and the quality of financial reporting, which are of critical importance to the successful operation of the U.S. capital markets.[20]

Internal Controls Audit

We have concerns about Sec. 4 because that provision would, in our view, unwisely expand the existing exemption for most public companies from the requirement to have effective internal controls.

More specifically, Sec. 4 would exempt an EGC from the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX). That section requires an independent audit of a company's assessment of its internal controls as a component of its financial statement audit.

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[19] We note that the U.S. Chamber of Commerce (Chamber) has publicly opposed the comparable accounting and auditing provisions contained in the companion bill H.R. 3606, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011." The Chamber indicated that they support removal of the provisions, commenting that "the opt-out for new accounting and auditing standards would create a bi-furcated financial reporting system with less certainty and comparability for investors, while creating increased liability risk for boards of directors, audit committees and Chief Financial Officers." Letter from R. Bruce Josten to The Honorable Spencer Bachus et al. 3 (Feb. 15, 2012) [hereinafter Josten], http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-2.15-HR2308_HR4014_HR3606_Bachus_Frank-3.pdf.

[20] Joint Letter, *supra* note 18, at 1.

The Council has long been a proponent of Section 404 of SOX.[21] We believe that effective internal controls are critical to ensuring investors receive reliable financial information from public companies.

We note that Section 989G(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) already exempts most public companies, including all smaller companies, from the requirements of Section 404(b).[22] We also note that Section 989G(b) of Dodd-Frank required the SEC to conduct a study on "how the Commission could reduce the burden of complying with section 404(b) . . . while maintaining investor protections . . . ."[23]

The SEC study, issued April 2011, revealed that (1) there is strong evidence that the provisions of Section 404(b) "improves the reliability of internal control disclosures and financial reporting overall and is useful to investors,"[24] and (2) that the "evidence does not suggest that granting an exemption [from Section 404(b)] . . . would, by itself, encourage companies in the United States or abroad to list their IPOs in the United States."[25] Finally, and importantly, the study recommends explicitly against—what Sec. 4 attempts to achieve—a further expansion of the Section 404(b) exemption.[26]

Availability of Information about Emerging Growth Companies

Finally, we have concerns about Sec. 6 of S. 1933 because it appears to potentially create conflicts of interest for financial analysts.

More specifically, we agree with the U.S. Chamber of Commerce that the provisions of Sec. 6 as drafted "may be a blurring of boundaries that could create potential conflicts of interests between the research and investment components of broker-dealers."[27] The Council membership supports the provisions of Section 501 of SOX and the Global Research Analyst Settlement.[28] Those provisions bolstered the transparency, independence, oversight and accountability of research analysts.[29]

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[21] *See, e.g.*, Letter from Jeff Mahoney et al. to The Honorable Spencer Bachus et al. 1 (Nov. 29, 2011), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2011/CAQ-CII%20404%20letter%2011-29-11.pdf (noting that companies "that do not have an audit of management's assessment of internal controls over financial reporting tend to have both significantly more material weaknesses in their internal controls and more restatements of their financial statements").

[22] Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376, § 989G(a) (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.

[23] *Id.* § 989G(b).

[24] Staff of the Office of the Chief Accountant of the Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002, at 112 (Apr. 2011), http://www.sec.gov/news/studies/2011/404bfloat-study.pdf.

[25] *Id.*

[26] *Id.* ("Dodd-Frank Act already exempted approximately 60% of reporting issuers from Section 404(b), and the Staff does not recommend further extending this exemption.").

[27] Josten, *supra* note 19, at 3 (commenting on the comparable provision in the companion bill H.R. 3606, the "Reopening American Capital Markets to Emerging Growth Companies Act of 2011").

[28] Council of Institutional Investors, Statement on Financial Gatekeepers 1 (Adopted Apr. 13, 2010), http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf.

[29] *Id.* ("The Sarbanes-Oxley Act of 2002 and the 'global settlement' with Wall Street firms in 2003 bolstered the transparency, independence, oversight and accountability of . . . equity analysts.").

While the Council welcomes further examination of issues, including potential new rules, relating to research analysts as gatekeepers, it generally does not support legislative provisions like Sec. 6 that would appear to weaken the aforementioned investor protections.[30]

The Council respectfully requests that the Committee carefully consider our questions and concerns about the provisions of S. 1933. If you should have any questions or require any additional information about the Council or the contents of this letter, please feel free to contact me at 202.261.7081 or Jeff@cii.org, or Senior Analyst Laurel Leitner at 202.658.9431 or Laurel@cii.org.

Sincerely,

Jeff Mahoney
General Counsel

CC: The Honorable Jack Reed, Chairman, Subcommittee on Securities, Insurance, and Investment

The Honorable Michael D. Crapo, Ranking Member, Subcommittee on Securities, Insurance, and Investment

[30] *Id.* at 2 ("The Council welcomes further examination of financial gatekeepers by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.").

AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

815 SIXTEENTH STREET, N.W.
WASHINGTON, D.C. 20006

RICHARD L. TRUMKA
PRESIDENT

ELIZABETH H. SHULER
SECRETARY-TREASURER

ARLENE HOLT BAKER
EXECUTIVE VICE-PRESIDENT

LEGISLATIVE ALERT!

(202) 637-5057

February 29, 2012

The Honorable Tim Johnson
Chairman, Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard Shelby
Ranking Member, Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

On behalf of the AFL-CIO, I am writing to express our strong opposition to the so-called "capital formation" bills pending before the Committee, which would reduce regulatory protections for investors in many companies. These investor protections are critical to safeguarding the retirement savings of America's workers from fraud and other risks. While the proponents of the "capital formation" bills claim they would promote jobs and economic growth, they would actually have the perverse effect of raising the cost of capital for all companies, by increasing the risk of fraud, and reducing the flow of information to investors.

The AFL-CIO opposes the following bills scheduled for consideration by the Committee:

The "Reopening American Capital Markets to Emerging Growth Companies Act" (S. 1933), which would let the vast majority of newly listed public companies delay compliance with a wide number of investor protections. S. 1933 would create dangerous new risks for investors by postponing the disclosure of audited financial statements, independent audits of internal controls, "say-on-pay" vote requirements, and restrictions on research analyst conflicts of interest.

The "Small Company Capital Formation Act" (S. 1544), which would increase the dollar limits on Regulation A offerings ten-fold and create a process for automatic increases every two years. Regulation A offerings allow companies to raise capital from the public without incurring the full reporting obligations of becoming a registered issuer. While S. 1544 includes enhanced investor protections for Regulation A offerings, a dollar limit on the amount that can be raised is needed to prevent abuses.

The "Access to Capital for Job Creators Act" (S. 1831), which would lift the Regulation D ban on public solicitation of accredited investors in unregistered securities. We are concerned that the existing definition of accredited investors includes many individuals who do not have the necessary financial expertise to properly evaluate the risks of Regulation D investments. Permitting the public solicitation of such investors through advertising and on the Internet will increase the risk of investor losses.

The "Democratizing Access to Capital Act" (S. 1791), which would let speculative start-up ventures raise money from small investors through so-called "crowdfunding" over the Internet. S. 1791 would increase the risk that small investors will be defrauded. While we question the need for legislation that enables crowdfunding, any such legislation must contain investor protections such as those included in the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act" (S. 1970).

The "Private Company Flexibility and Growth Act" (S. 1824), which would quadruple the permitted number of shareholders of record in private companies before such companies are required to register with the Securities and Exchange Commission (SEC). Because multiple beneficial shareholders can he counted as one "shareholder of record," this bill will allow broadly-held companies to avoid going public. Instead, all beneficial shareholders should be counted to determine whether a company must register with the SEC.

Lowering regulatory standards will not promote capital formation or create johs. Rather, experience shows that weakened securities regulations increase the danger of fraud and speculation. The U.S. should take heed of the experiments of other developed countries with lax regulatory standards that have created treacherous capital markets for investors, such as Canada's now-defunct Vancouver Stock Exchange and the London Stock Exchange's Alternative Investment Market.

In sum, these bills would weaken investor confidence in our capital markets by creating new and expanded loopholes in our securities laws. The U.S. capital markets are among the safest and most liquid in the world because they afford vigorous investor protections. These bills will create additional risks for investors and drive up capital costs, thereby offsetting any reduction in compliance costs for smaller companies. For these reasons, we urge you to side with investors and oppose these bills.

Sincerely,

William Samuel, Director
GOVERNMENT AFFAIRS DEPARTMENT

cc: Members of the Senate Committee on Banking, Housing, and Urban Affairs

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

February 15, 2012

To: Members of the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Dear Senator:

We understand that the Committee expects to turn its attention in coming weeks to the various legislative proposals that have been put forward to promote job growth by reducing supposed barriers to capital formation. Americans for Financial Reform ("AFR") is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based and business groups along with prominent independent experts. As such, we have a strong interest in ensuring that policy proposals to promote job growth don't undermine the protections we rely on to keep our capital markets honest and transparent.

With millions of Americans still out of work in the wake of the recent financial crisis, we agree that an exploration of job creation strategies is timely. Moreover, given the central role that our capital markets play in the job creation process and the dramatic changes that have occurred in those markets over the past few decades, it is appropriate that any such review include a careful analysis of whether companies of all sizes and at all stages of development have access to the capital they need to grow and prosper. We are concerned, however, that current legislative proposals rely too heavily on anecdotal evidence of a problem and ideologically driven "solutions." As the bills have raced through the House, too little study has been devoted to determining the true underlying causes of the recent drop in small company IPOs to allow for appropriately targeted legislative solutions. And inadequate attention has been given to the implications of proposed regulatory changes for investors. As a result, the proposals currently under consideration risk exposing investors to a new round of fraud and abuse without producing any meaningful or sustainable job growth.

In keeping with its traditional more deliberative approach, this Committee has an opportunity to provide the careful analysis that so far has been lacking. Toward that end, we offer the following brief views regarding the risks to investors posed by each of the bills currently under consideration. We hope you will take these views into account as you decide whether and how to move forward on the various bills before you.

- **IPO On-Ramp (S. 1933)**

We strongly oppose this bill, which legitimizes the idea that companies should be allowed to go public and raise money from average, retail investors without being able to meet basic standards designed to ensure that they provide those investors with accurate and reliable information on which to base their investment decisions. S. 1933 would give new companies, including all but the very largest such companies, up to five years to raise money from the public without complying with SOX 404(b). Since the Sarbanes-Oxley Act was implemented, research has shown that requiring an independent audit of internal controls results in higher quality financial reporting and fewer restatements. Moreover, experience with implementation of SOX tells us that, absent an independent controls audit, all too many managers will attest to the adequacy of clearly deficient control systems. As a result, delaying implementation of the independent internal controls audit would significantly increase the risk that companies would face both a material weakness report and higher costs to fix inadequate controls once the independent audit requirement kicked in. For these reasons, companies as well as investors would be far better off building their systems to be SOX 404(b) compliant from the outset.

Like the provision to delay implementation of SOX 404(b), the proposal to weaken restrictions on research analysts ignores the widespread fraud and abuse that led to their adoption. Moreover, it ignores recent research suggesting that there has been no recent decline in post-IPO analyst coverage.[1] The legislation also includes a number of other special interest provisions that clearly have nothing to do with eliminating barriers to capital formation, such as delaying compliance with shareholder say-on-pay and golden parachute voting requirements as well as compensation disclosure requirements. And it includes an extremely poorly thought out proposal to delay implementation of accounting and auditing standards for new companies. The result of the latter proposal would be less transparent markets, with competing companies reporting financial data using different rules depending on whether they were an established or emerging company. Auditing would be less efficient as well, as audit firms would be required to train their auditors to comply with different auditing standards for different clients. Moreover, this is precisely the sort of attack on the independence of the standard-setting process that this Committee has traditionally opposed under Democratic and Republican leadership alike.

Because it ignores the real reasons that small companies have become less likely to opt for an early-stage IPO (changes in the profitability of small independent companies, the institutionalization of the markets, changes to Regulation D, and changes to the economics of the broker-dealer business model, to name a few), S. 1933 exposes investors to these risks without offering any realistic prospect that it will promote sustainable job growth. It should not become law.

- **Crowd-funding (S. 1970, S. 1791)**

[1] Ritter, Jay R., Gao, Xiaohui and Zhu, Zhongyan, Where Have All the IPOs Gone? (November 4, 2011). Available at SSRN: http://ssrn.com/abstract=1954788 or http://dx.doi.org/10.2139/ssrn.1954788. This article also calls into question the argument that the Sarbanes-Oxley Act is behind the last decade's drop in IPOs.

Crowd-funding is a gimmick that offers little prospect of meaningful job creation and the significant risk that most individuals who invest in the highly speculative start-ups that rely on crowd-funding for capital will lose some or all of their money. That said, there is a very real difference between the various crowd-funding bills in terms of their potential to protect investors from fraud and abuse. While both Senate bills are preferable to the House bill, only S. 1970 includes a robust set of investor protections commensurate with the risks of crowd-funding. Its provisions to set an aggregate investment cap, require SEC registration and oversight of crowd-funding portals, to impose appropriate regulatory obligations on crowd-funding portals, and to preserve state authority are a must. Making it easier for average, unsophisticated Americans to risk their money in such ventures is questionable policy at best. At the very least, we urge you to insist on inclusion of S. 1970's provisions to ensure that crowd-funding doesn't also become a mecca for fraud.

- **Regulation A Revisions (S. 1544)**

  This legislation dramatically increases the amount of capital that companies can raise from the public without triggering the full reporting and other obligations that go with registration. While we cannot support this legislation in its current form, we do recognize that the sponsors have made a good faith effort to balance easier access to capital with appropriate investor protections, including up-front disclosures, periodic reporting, audited financial statements, SEC oversight, and a negligence-based litigation remedy. A relatively few revisions could be adopted that would address our remaining concerns.

  As written, the bill would permit companies to game the system and avoid full registration and reporting requirements by repeatedly conducting Regulation A offerings. Imposing a cumulative, multi-year cap on use of Regulation A exemption should address that concern. In addition, we are concerned that, even as the legislation dramatically increases the ceiling for Regulation A offerings from $5 million to $50 million, it places no restriction on the ability of the SEC to increase it further. We urge you to cap the amount that the SEC could raise the ceiling without congressional approval. In addition, while we appreciate the inclusion of a negligence-based liability remedy in the legislation, we believe that strict liability is the appropriate standard to better ensure accurate disclosures in this loosely regulated market.

  These changes would minimize the potential for investor harm while still significantly expanding access to Regulation A offerings.

- **Regulation D Revisions (S. 1831)**

  We strongly oppose this legislation, which would remove the prohibition on public solicitation of investors in the sale of unregistered offerings. We are sympathetic to the argument that the current media environment makes it all but impossible for companies

in which there is significant media interest to abide by Regulation D solicitation restrictions. However, Regulation D offerings are an area that is already rife with abusive conduct. Any measure to address this issue must take both these problems into account. Supporters of eliminating the general solicitation prohibition argue that, since sales are limited to sophisticated investors, it is unnecessary to also limit the means by which they can be sold. There are several fallacies embedded in that argument. First, the legislation as drafted is not limited to those Regulation D offerings that are sold strictly to accredited investors. Second, because of shortcomings in the definition of accredited investor, many accredited investors are not financially sophisticated. Third, NASAA has documented extensive evidence of non-compliance with existing requirements, a problem that would only get worse if current restrictions were loosened.

While this is an issue that deserves further attention, the current legislative proposal would create more problems that it would solve. It should be shelved while a more responsible and balanced approach to the issue can be developed.

- **Shareholder Thresholds (S. 1824)**

  We strongly oppose this bill, which makes it easier for companies with a large number of highly dispersed investors to avoid providing the periodic disclosures on which transparent markets depend. It does this by simultaneously raising the limit on the number of shareholders of record who can hold a stock without triggering reporting requirements from 500 to 2,000 and exempting employees who hold company stock from the count. In addition, it would allow banks and bank holding companies to "go dark" if the number of shareholders of record dropped below 1,200. Moreover, it does all this without addressing the outdated and easily manipulated reliance on "shareholders of record" in making this determination.

  As a general matter, we question the wisdom of reducing both market transparency and the incentives companies have to go public. Moreover, we've seen no clear explanation for why lifting these restrictions is necessary or justified. We are particularly concerned that this legislation would raise these limits, and raise them dramatically, without addressing the outdated reliance on shareholder of record, a measure that can easily be manipulated. At the very least, we would urge the Committee to use a measure, such as beneficial owner, that is less subject to manipulation and less likely to permit even very large companies with large numbers of investors to evade basic reporting requirements. Ideally, we encourage the Committee to give this issue further study before taking action.

Investors have endured an unremitting stream of scandals, frauds, and financial crises over the past decade. The effect on investor confidence has been devastating. Equally devastating has been the effect on the economy, capital formation, and jobs. A policy that relies on rolling back investor protections and undermining market transparency will not produce sustainable job growth and will instead further undermine investors' confidence in the integrity of our capital markets. Instead of rushing through these poorly conceived legislative proposals, we urge you to

take the time to study the issue in order to produce the thoughtful jobs package that Americans so desperately need.

Sincerely,

Americans for Financial Reform

Cc: Members, U.S. Senate

EXHIBIT 4

Importance of Independent Standard Setters

From: http://shelby.senate.gov/public/index.cfm/newsreleases?ContentRecord_id=DCB122D6-9912-4AD3-84AF-AAB8BCFC8360

Home / Newsroom / News Releases
Sep 29 2004

SHELBY SPEECH AT LAFFER CONFERENCE

"Another issue that has received a great deal of attention lately is the debate over the expensing of stock options. This is an area that I, along with Ranking Member Paul Sarbanes, Fed Chairman Alan Greenspan and SEC Chairman Donaldson believe should be left for the experts at the Financial Accounting Standards Board to determine. There are currently several legislative initiatives in Congress that would attempt to override the experts at FASB, who have determined that stock options should be counted as an expense. **This would be a monumental mistake. The market credibility of the U. S. is at stake in this debate. If we are to retain credibility in the global marketplace, then it is critical that Congress resist the temptation to put politics ahead of principles. If anything other than sound accounting principles becomes the basis for FASB's rules, then our markets will become less certain and lack credibility.** International standards already require expensing, and the U. S. risks falling behinds. If our standards are seen as inadequate, U. S. companies may suffer the consequences of less liquidity and restricted access to capital. From the collapse of Enron and Worldcom, we learned the value of accurate financial information based on independent and objective accounting standards. It seems to be that some in Congress are trying to pre-empt the very action that we encouraged only two years ago during Sarbanes-Oxley. We need investors to be able to trust our markets, and this can only happen with honest accouting. Congress has treaded down this road before. In the mid-90's, FASB proposed the expensing of stock options. When Congress threatened to revoke its authority to set accounting standards, FASB withdrew its proposal and adopted a rule requiring footnote disclosure of stock-option values, failing to treat options as an expense. I do not want to see Congress make the same mistake twice. While there are differing opinions on the effect expensing options would have on business, a recent study of 300 firms that voluntarily expensed options found that their share prices were not affected by the change – a sign that the markets may weigh options efficiently. Indeed, not only have companies such as Coke, Exxon and Walmart decided to expense options, but also technology companies such as Amazon, Microsoft, IBM and Netflix."

ACCOUNTING REFORM AND INVESTOR PROTECTION
VOLUME I

S. Hrg. 107-948

ACCOUNTING REFORM AND INVESTOR PROTECTION

HEARINGS

before the

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

VOLUME I

ON

THE LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002:
ACCOUNTING REFORM AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER PUBLIC COMPANIES

FEBRUARY 12, 14, 26, AND 27, 2002

"That public companies would try to make things sound as positive as they can to the investing public does not surprise me. Obviously, they have a strong interest in driving up their share prices.

This self-interest, however, has long been recognized. To

counter it, our financial markets have traditionally relied on the independent, objective analysis of audits performed by certified public accountants.

The outside audit gave investors confidence that corporate numbers did not come from the Land of Make Believe. Investors could make decisions knowing that, for whatever risks they were taking, at least the financial information had been reviewed and certified as true by an unbiased party."

"Mr. Chairman, there are additional but perhaps less tangible losses associated with the unchecked flow of bad financial information in the marketplace. When some companies put out inaccurate information about their financial condition, investors cannot make informed investment decisions. They make choices based on appearances instead of reality. What results is that good companies that provide useful goods and services fail to attract their fair share of capital because less valuable companies look better on paper. Our society suffers because the development of new and better products and services are delayed or perhaps never occurs.

When auditing failures result in good investments on paper being bad investments in reality, capital does not flow to its best use, the market does not properly reward innovation, and over time, the firms that lose out themselves see the value of cooking the books."

The Washington Post

Weakening A Market Watchdog

An Accounting Rule Change's Real Costs

By Arthur Levitt
Thursday, March 26, 2009

Confidence, trust, and numbers that investors can believe in are the stuff that make or break the capital markets. When investors question the validity of numbers, they sell and wait, rather than buy and invest.

Yet those charged with building confidence and trust and presenting numbers that can be believed are under sustained attack -- and they are losing. Over the past few weeks, banks and their supporters in Congress have applied significant pressure on the Financial Accounting Standards Board (FASB) to rewrite standards for valuing distressed assets on bank balance sheets.

Earlier this month, Robert Herz, chairman of the FASB, was lectured by members of the House Financial Services Committee. "Don't make us tell you what to do," said Rep. Randy Neugebauer (R-Tex.). "Just do it. Just get it done." Said Rep. Gary L. Ackerman (D-N.Y.): "If you don't act, we will."

This is like being forced to give your boss several mulligans in a round of golf. And so last week, the FASB voted to propose allowing banks to obscure -- some might say bury -- the full extent of impairments on many of the bad loans and investments they made and securitized over the past few years. These impairments have traditionally been valued at market prices (thus, the phrase "mark-to-market"), so that investors can know what the banks would stand to lose if those investments were sold today.

The FASB's proposal goes against what we know investors prefer: Stronger rules for the reporting of changes in the values of investments in income statements. Under the proposed rule, no matter how toxic the investment, whether it's a penny stock or the bonds of a government ward such as AIG, companies can choose to largely ignore the fundamental reasons behind the investments' decline. All that companies have to do is say they don't intend to sell those investments until their value rebounds.

Such a subjective judgment is bound to decrease investor confidence in reported income. And in a strange twist of fate, the FASB's proposals may create even greater opportunities for short sellers who are adept at digging into numbers that do not tell the whole story.

Yet the real scandal here is not the decision by the FASB -- with which I strongly disagree but which others might be able to defend. Rather, it is how the independence of regulators and standard-setters is being threatened. This isn't just about the income statements of banks. It's about further eroding investor confidence, precisely at a moment when investors are practically screaming for more protection.

The FASB was created to stand apart from partisanship and momentary shifts in public opinion precisely because the value of accounting standards comes in the consistency of their application over time and circumstance. Chairman Herz acquiesced, it appears, in order to keep Congress from invading FASB turf. Yet in seeking to protect its independence, the board has surrendered some of it in the bargain.

Every regulatory agency should take note: Independence from public pressure has a value, and when

you give some of it away, you've lost something that takes years to rebuild. Just ask the Federal Reserve, which lost its reputation for independence from political pressure in the early 1970s and didn't regain it for a decade.

In the past, the FASB has made significant changes to its rules only after significant due process, including comment periods that often lasted for three months and a full discussion reflecting those public comments. The rule change agreed to by the FASB on Tuesday followed only one public meeting on this topic, and the board is giving investors just two weeks to comment, with a final vote the next day. This is a rush job.

The FASB should rethink its approach to these rules. The board should develop new standards providing investors with improved disclosures regarding the quality of banks' assets. More information is needed on the ratings the banks and regulators place on their loans. And above all, the Securities and Exchange Commission should take a firm stand on the side of investors and vigorously resist all political efforts to reduce the independence of financial rule-making agencies and boards.

Investors once believed that U.S. markets were sufficiently protected from political pressure and manipulation by a system of interlocking independent agencies and rule-making bodies -- some government-run, some not. That system is being dismantled, piece by piece, by political jawboning and rushed rule rewrites. Now, investors find themselves with fewer protections and weakened protectors.

The writer, a senior adviser to the Carlyle Group, was chairman of the Securities and Exchange Commission from 1993 to 2001.

THE WALL STREET JOURNAL.
WSJ.com

OPINION | March 24, 2008

We Need Honest Accounting

Relax regulatory capital rules if need be, but don't let banks hide the truth.

By JAMES S. CHANOS

Mark-to-market (MTM) accounting is under fierce attack by bank CEOs and others who are pressing Congress to suspend, if not repeal, the rules they blame for the current financial crisis. Yet their pleas to bubble-wrap financial statements run counter to increased calls for greater financial-market transparency and ongoing efforts to restore investor trust.

Getty Images

We have a sorry history of the banking industry driving statutory and regulatory changes. Now banks want accounting fixes to mask their recklessness. Meanwhile, there has been no acknowledgment of culpability in what top management in these financial institutions did -- despite warnings -- to help bring about the crisis. Theirs is a record of lax risk management, flawed models, reckless lending, and excessively leveraged investment strategies. In the worst instances, they acted with moral indifference, knowing that what they were doing was flawed, but still willing to pocket the fees and accompanying bonuses.

MTM accounting isn't perfect, but it does provide a compass for investors to figure out what an asset would be worth in today's market if it were sold in an orderly fashion to a willing buyer. Before MTM took effect, the Financial Accounting Standards Board (FASB) produced much evidence to show that valuing financial instruments and other difficult-to-price assets by "historical" costs, or "mark to management," was folly.

The rules now under attack are neither as significant nor as inflexible as critics charge. MTM is generally limited to investments held for trading purposes, and to certain derivatives. For many financial institutions, these investments represent a minority of their total investment portfolio. A recent study by Bloomberg columnist David Reilly of the 12 largest banks in the KBW Bank Index shows that only 29% of the $8.46 trillion in assets are at MTM prices. In General Electric's case, the portion is just 2%.

Why is that so? Most bank assets are in loans, which are held at their original cost using amortization rules, minus a reserve that banks must set aside as a safety cushion for potential future losses.

MTM rules also give banks a choice. MTM accounting is not required for securities held to maturity, but you need to demonstrate a "positive intent and ability" that you will do so. Further, an SEC 2008 report found that "over 90% of investments marked-to-market are valued based on observable inputs."

Financial institutions had no problem in using MTM to benefit from the drop in prices of their own notes and bonds, since the rule also applies to liabilities. And when the value of the securitized loans they held was soaring, they eagerly embraced MTM. Once committed to that accounting discipline, though, they were obligated to continue doing so for the duration of their holding of securities they've marked to market. And one wonders if they are as equally willing to forego MTM for valuing the same illiquid securities in client accounts for margin loans as they are for their proprietary trading accounts?

But these facts haven't stopped the charge forward on Capitol Hill. At a recent hearing, bankers said that MTM forced them to price securities well below their real valuation, making it difficult to purge toxic assets from their books at anything but fire-sale prices. They also justified their attack with claims that loans, mortgages and other securities are now safe or close to safe, ignoring mounting evidence that losses are growing across a greater swath of credit. This makes the timing of the anti-MTM lobbying appear even more suspect. And not all financial firms are calling for loosening MTM standards; Goldman Sachs and others who are standing firm on this issue should be applauded.

According to J.P. Morgan, approximately $450 billion of collateralized debt obligations (CDOs) of asset-backed securities were issued from late 2005 to mid-2007. Of that amount, roughly $305 billion is now in a formal state of default and $102 billion of this amount has already been liquidated. The latest monthly mortgage reports from investment banks are equally sobering. It is no surprise, then, that the largest underwriters of mortgages and CDOs have been decimated.

Commercial banking regulations generally do not require banks to sell assets to meet capital requirements just because market values decline. But if "impairment" charges under MTM do push banks below regulatory capital requirements and limit their ability to lend when they can't raise more capital, then the solution is to grant temporary regulatory capital "relief," which is itself an arbitrary number.

There is a connection between efforts over the past 12 years to reduce regulatory oversight, weaken capital requirements, and silence the financial detectives who uncovered such scandals as Lehman and Enron. The assault against MTM is just the latest chapter.

Instead of acknowledging mistakes, we are told this is a "once in 100 years" anomaly with the market not functioning correctly. It isn't lost on investors that the MTM criticisms come, too, as private equity firms must now report the value of their investments. The truth is the market is functioning correctly. It's just that MTM critics don't like the prices that investors are willing to pay.

The FASB and Securities and Exchange Commission (SEC) must stand firm in their respective efforts to ensure that investors get a true sense of the losses facing banks and investment firms. To be sure, we should work to make MTM accounting more precise, following, for example, the counsel of the President's Working Group on Financial Markets and the SEC's December 2008 recommendations for achieving greater clarity in valuation approaches.

Unfortunately, the FASB proposal on March 16 represents capitulation. It calls for "significant judgment" by banks in determining if a market or an asset is "inactive" and if a transaction is "distressed." This would give banks more discretion to throw out "quotes" and use valuation alternatives, including cash-flow estimates, to determine value in illiquid markets. In other words, it allows banks to substitute their own wishful-thinking judgments of value for market prices.

The FASB is also changing the criteria used to determine impairment, giving companies more flexibility to not recognize impairments if they don't have "the intent to sell." Banks will only need to state that they are more likely than not to be able to hold onto an underwater asset until its price "recovers." CFOs will also have a choice to divide impairments into "credit losses" and "other losses," which means fewer of these charges will be counted

against income. If approved, companies could start this quarter to report net income that ignores sharp declines in securities they own. The FASB is taking comments until April 1, but its vote is a fait accompli.

Obfuscating sound accounting rules by gutting MTM rules will only further reduce investors' trust in the financial statements of all companies, causing private capital -- desperately needed in securities markets -- to become even scarcer. Worse, obfuscation will further erode confidence in the American economy, with dire consequences for the very financial institutions who are calling for MTM changes. If need be, temporarily relax the arbitrary levels of regulatory capital, rather than compromise the integrity of all financial statements.

Mr. Chanos is chairman of the Coalition of Private Investment Companies and founder and president of Kynikos Associates LP.

Please add your comments to the Opinion Journal forum.

EXHIBIT 5

"Star Analysts" and Reversion to Past Behavior

Post Expiration of Wall Street Settlement

From:http://dealbook.nytimes.com/2011/08/20/star-analysts-are-back-no-autographs-please/

Star Analysts Are Back (No Autographs, Please)

By SUSANNE CRAIG

Minh Uong/The New York Times

THEY are the new tastemakers of Web investing, the supposed seers of Bubble-Tech 2.0. And despite the stock market's recent craziness, they are almost as hot as some of the stocks they cover.

Long after star analysts of the dot-com era self-destructed, along with Pets.com and its sock puppet, a new generation of Wall Street researchers is grabbing attention — and a lot of money.

These Internet analysts are nowhere nearly as famous (or infamous) as Jack Grubman and Henry Blodget, who came to symbolize the conflicted, let's-put-lipstick-on-this-pig research of the dot-com era. Nor are they as influential as Mary Meeker, the onetime Queen of the Net at Morgan Stanley, whose pronouncements captivated the investing public in the late 1990s.

But not since those heady days of the Nasdaq stock market bubble has working as a technology analyst seemed so, well, sexy. Even as the economy wobbles again, there's money to be made in providing banking advice to big names like Facebook. And the great investment houses are sparring over specialists in Web search and social media, who are hired to tell the stories of these hot companies to investors. Such analysts have been jumping from one bank to another, chasing the highest offer. Today,

some of these analysts are pulling down several million dollars a year — figures that, not so long ago, would have been almost unthinkable.

Graphic: Three Analysts' Stock Recommendations (Click for Larger Image)

Even in Wall Street circles, some people wonder whether all of this is another sign that Internet mania is again spinning out of control. Add to this the recent turbulence in the financial markets — including big declines in technology stocks — and you might conclude that some analysts yet again were telling investors to buy at exactly the wrong time.

Gustavo G. Dolfino, president of a Wall Street recruitment firm, the WhiteRock Group, has conducted searches for roughly a dozen analyst positions so far this year, versus seven in all of 2010.

"It is red-hot out there," Mr. Dolfino says. Whether the bull market in technology specialists will last if the economy and markets sour is anyone's guess. Hype or not, talk that companies like LinkedIn, Facebook and Groupon will change the way we live and do business — and make their shareholders rich in the process — has Wall Street pining for the fees that come with taking these companies public. And, in turn, the banks need people who can explain these companies to investors and, hopefully, spot the right time to buy or sell.

Banking executives rarely talk publicly about how much they pay employees, particularly their stars. **But privately, insiders at several banks have been buzzing about a number of Internet analysts who made big-money moves this year.** According to people familiar with the compensation of various analysts, here are three analysts who have done well of late:

Douglas Anmuth was lured to JPMorgan Chase earlier this year with a pay package valued at roughly $2 million. He had been making about $1.3 million at Barclays Capital, an arm of the British bank.

Heather Bellini landed at Goldman Sachs with a remarkable pay package worth almost $3 million. And Mark Mahaney, whom JPMorgan tried to hire with an offer of about $3 million, stayed on at Citigroup — after getting a raise.

The three analysts, as well as media officers for the banks, declined to comment for this article.

ON the surface, the work of a stock analyst might seem straightforward. You size up companies, run the numbers, handicap potential winners and losers and issue one of three classic stock recommendations: buy, hold or sell.

In practice, it's more complicated than that. **Even after the dot-com imbroglio, the subsequent research scandal, the financial collapse of 2008-9 and all the ups and downs in between, Wall Street rarely says "sell."**

Even now, for instance, **just a handful of the 38 analysts who cover Bank of America, one of the worst-performing stock in the Dow Jones industrial average so far this year, have a "sell" recommendation on it,** according to Bloomberg. Nor, according to that data, are there very many sells on I.B.M., Microsoft, Yahoo, General Motors, General Electric, Google or Apple — the list goes on.

One possible explanation is that Wall Street research reflects the inherent optimism of the marketplace — the attitude that says, "Hey, you gotta believe!" Another is that Wall Street is in the business of advising corporations and selling investments, so why bother trashing too many stocks?

Whatever the case, analysts have typically ranked far below traders and bankers in Wall Street's pecking order, in both pay and prestige. **Headliners of the 1990s like Mr. Blodget, Mr. Grubman and Ms. Meeker broke out by becoming the public faces of Wall Street.**

Late in that decade, after Mr. Blodget correctly predicted that the share price of Amazon.com would vault above $400 — from less than $250 at the time — a new phrase entered the investment lexicon: to "Blodget" a stock. It meant that analysts could cause such a stir with seemingly over-the-top predictions that those predictions would become self-fulfilling.

But the Nasdaq collapse laid bare conflicts at the heart of the Wall Street research machine. Many analysts, it turned out, were pushing stocks to help their banks win lucrative investment banking business. They were issuing favorable research reports and pitching corporate clients to clinch deals. It was good fun while it lasted, at least for some top analysts, who were pulling down $15 million or even more a year.

Regulators cracked down. As part of a landmark settlement over research in 2003, major banks paid a $1.4 billion fine. Mr. Blodget and Mr. Grubman were banished from the securities industry. (Mr. Blodget is now editor in chief and C.E.O. of the Business Insider, a business and news Web site. Mr. Grubman is a managing partner at the Magee Group, giving strategic advice to telecom, media and tech companies.)

The settlement forced banks to change the way their research departments operated. To avoid conflicts of interest, banks were barred from subsidizing analyst research with revenue from their investment-banking operations. Regulators specified that analysts be paid based on seniority, experience, quality of research and the demand for their services in the marketplace — not on the deals they help wrangle.

Wall Street research has been searching for a viable business model ever since. Without the rich backing of investment banking, analysts' pay plummeted. In 2001, analysts earned an average of $1.45 million. By 2005, that figure had dropped to less than $800,000, according to a study by three Harvard professors, Boris Groysberg, Paul M. Healy and David A. Maber. Professor Healy says research budgets have been cut sharply, and people who run research departments agree. One says his analysts, on average, now earn about $700,000 a year in salary and bonus.

Granted, many ordinary Americans would be thrilled to make $700,000 a year. But on Planet Wall Street, it has been a big letdown for former stars.

The 2003 Wall Street analyst settlement, led by Eliot Spitzer when he was the New York attorney general, still haunts the industry. Banks are often reluctant to give raises to analysts who cover industries in which their investment bankers are particularly active, for fear of drawing regulators' attention.

But just when you think the glory days of Wall Street analysts are over, the bidding wars for the new breed of Internet analysts suggest otherwise.

WHATEVER financial pros say about the numbers and the metrics, the stock market is often about stories. What companies capture the imagination? Inspire a little old-fashioned greed or fear?

One big story right now is social media. After LinkedIn went public at $45 a share this year, its share price shot as high as $122.91. The run-up gave LinkedIn one of the highest valuations, based on its ratio of stock price to earnings, of any nonfinancial company in the United States.

Was Wall Street insane? It was great news for LinkedIn investors, and for companies like Facebook, which appears set to go public in the next year. Recent private investments in Facebook have valued that company at more than $100 billion.

Some analysts are still upbeat. LinkedIn's stock has since come off the boil, closing at $79.03 on Friday. But of the six analysts who cover the stock regularly, according to Thomson Reuters, two say "buy." Three have "hold" recommendations, and one has an "underperform" rating on it, which means you should really start thinking about selling.

Given the heat in this market, tech analysts are sitting pretty. The 2003 settlement laid out conditions under which analysts can get pay raises. One easy way is to get a job offer from a rival bank.

"We have some leeway in pay," says a bank research executive, who spoke on the condition that he not be identified for fear of tipping his hand to competitors. "But once an analyst has a competing offer, we can move if we want to bump pay substantially."

But analysts are a bit like stocks: they go in and out of style and are often hostage to marketplace whims. Those who happen to cover booming industries, or sectors ripe for takeovers, tend to get the most attention. Oil, mining, information technology, emerging economies — these areas are of particular focus to investors today, and, therefore, so are the analysts who cover them.

Bryan Keane, an analyst who covers technology service companies like Accenture, got a pay bump of several hundred thousand dollars for moving to Deutsche Bank from Credit Suisse, according to people with knowledge of his pay. Mr. Keane and Deutsche Bank officials declined to comment.

But Internet analysts are by far the hottest commodities. That is partly a function of the story, partly a function of supply. At the height of the dot-com boom, no fewer than 616 Wall Street analysts were covering Internet companies. Today, the figure is 362, according to data from Thomson Reuters.

And fewer than a dozen of those specialize in social networking stocks, as Mr. Anmuth does. Mr. Mahaney at Citigroup covers Pandora, and some people expect he will cover Facebook. As long as investors bid up these stocks, Wall Street will keep bidding up the price of its analysts.

BUT for better or worse, it seems unlikely that this new class of Internet analysts will ever rival the dot-com generation in reach and influence. The irony is that the Web, which these analysts embrace and celebrate, has actually shrunk their roles in the marketplace. These days, investors trawl through blogs and comment posts, run their own numbers and compare notes with other investors. Analysts are no longer the only game in town for insight and advice.

And, of course, there is the matter of trust, and whether analysts as a group can ever fully regain it. Some of the tarnish of the dot-com era has stuck. Inside banks, analysts no longer have their old cachet because they can no longer help bring in investment-banking business.

The good news is that some of today's Internet analysts seem more tempered in their predictions than their predecessors did.

In late June, Mr. Anmuth issued a positive report on LinkedIn after his employer, JPMorgan, helped take the company public. LinkedIn, he wrote, was "disrupting both the online and offline job recruitment markets." With the stock then trading at around $76, he set a price target of $85.

But on July 18, after shares of LinkedIn raced past $100, Mr. Anmuth pulled back. He downgraded his rating from overweight to neutral. Whether investors will listen is anyone's guess.

EXHIBIT 6

Investment Companies Institute

On

General Solicitation

INVESTMENT COMPANY INSTITUTE

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October 9, 2007

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Revisions of Limited Offering Exemptions in Regulation D; File No. S7-18-07

Dear Ms. Morris:

The Investment Company Institute[1] appreciates this opportunity to comment on the Commission's proposed amendments to Regulation D under the Securities Act of 1933, in particular the limited advertising provision of proposed Rule 507.[2] The Institute strongly opposes this provision because it represents a dangerous erosion of the long-established line between public and private securities offerings. Moreover, we believe the Commission has failed to demonstrate that allowing limited advertisements for private securities offerings is necessary or appropriate in the public interest and consistent with the protection of investors.

If the Commission nevertheless determines to adopt Rule 507, the Institute urges that the rule be adopted substantially as proposed. As the Proposing Release indicates, one consequence of the Commission's approach is that pooled investment vehicles excluded from the definition of "investment company" under the Investment Company Act of 1940 (collectively, "private investment pools") would not be able to rely on Rule 507. The Institute firmly believes that this is the appropriate result, for compelling legal and policy reasons. We further recommend that the Commission take this opportunity to reiterate that allowing any form of general solicitation or general advertising by private investment pools is fundamentally inconsistent with their exclusion from the Investment Company Act.

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[1] The Investment Company Institute is the national association of the U.S. investment company industry. More information about the Institute is available at the end of this letter.

[2] SEC Release Nos. 33-8828 and IC-27922 (Aug. 3, 2007), 72 Fed. Reg. 45116 (Aug. 10, 2007) ("Proposing Release"). Page number citations in this letter reference the Proposing Release as posted on the Commission's website, which is available at http://www.sec.gov/rules/proposed/2007/33-8828.pdf.

These positions, which are outlined in detail below, reflect the Institute's firm conviction that the Commission must maintain a strict demarcation between public and private offerings of securities. No less strong is our belief that the Commission must ensure the highest level of investor protection possible with respect to unregistered offerings of securities. In keeping with these broad principles, the Institute recommends that the Commission take the following courses of action in addressing selected other aspects of its proposal:

- Adopt the proposed "accredited natural person" standard for investors in private investment pools organized under Section 3(c)(1) of the Investment Company Act, but without an exclusion for venture capital funds.[3]

- Adjust all dollar thresholds in the accredited investor standards in Rule 501 of Regulation D by making: (1) an immediate adjustment that would correct for the substantial erosion in those standards over the period from 1982, when they were first adopted, to the present; and (2) regular adjustments every five years thereafter to prevent future erosion. The dollar thresholds in the accredited natural person standard in proposed Rule 509 of Regulation D should be similarly adjusted every five years.[4]

- Adopt the proposed "bad actor" disqualification provisions for all securities offerings under Regulation D.

- Continue to exclude manner of sale violations from the list of insignificant deviations from Regulation D in Rule 508.[5]

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[3] Our position on this proposed standard is discussed more fully on pages 12-13 and in the comment letter filed by the Institute when this provision was first proposed in 2006. *See infra* note 31. *See also* Commissioner Paul S. Atkins, Remarks Before the Federal Reserve Bank of Chicago Seventh Annual Private Equity Conference (Aug. 2, 2007), available at http://www.sec.gov/news/speech/2007/spch080207psa.htm (questioning whether there is a "principled reason" for treating venture capital funds differently and suggesting that such funds "should not get too comfortable with their exclusion").

The Institute recognizes that several different sophistication standards already exist for specific types of exempt transactions (*e.g.*, "qualified purchaser," "qualified client," "qualified institutional buyer") and that the adoption of yet two more – "accredited natural person" and "large accredited investor" – would increase complexity for issuers and could have the unintended effect of causing compliance failures. The Institute would support an effort to harmonize the various standards for investing in offerings intended for sophisticated investors, and ultimately reduce the number of such standards, provided that investment thresholds remain high and there is no reduction in investor protection.

[4] Our position on this issue is discussed more fully on pages 14-15.

[5] *See* Proposing Release at 24 (specifically requesting comment on whether the Commission should "delete the current Rule 508 carve-out of manner of sale limitations in the list of insignificant deviations").

Publication of Limited Announcements Under Proposed Rule 507

1. **Publication of Rule 507 Limited Announcements would be Inconsistent with the Longstanding Prohibition Against General Solicitation and General Advertising in Unlimited Offerings of Unregistered Securities**

Proposed Rule 507 would establish a new exemption from Securities Act registration for certain offerings to "large accredited investors," as defined in the rule. It would allow private issuers – for the first time – to publish tombstone-like announcements in print media and on the Internet to facilitate the sale of an unlimited amount of unregistered securities to eligible investors.

The Rule 507 proposal represents a dramatic departure from the Commission's longstanding, and logical, position that general solicitation or general advertising is not permissible as part of an offering of unregistered securities. Until this proposal, the Commission had always considered an offering of unregistered securities that is unlimited as to the amount offered to be a *private* offering – or more precisely, a transaction "not involving any public offering" within the meaning of Section 4(2) of the Securities Act – if conducted under the express conditions of Regulation D or the more limited conditions applicable to offerings under Section 4(2). In a 1962 release discussing the scope of the Section 4(2) exemption, the Commission explained that whether a transaction does not involve a public offering is a question of fact, based upon consideration of all surrounding circumstances.[6] On the issues of solicitation and advertising, the Commission stated:

> Consideration must be given not only to the identity of the actual purchasers but also to *the offerees*. Negotiations or conversations with or general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though ultimately there may only be a few knowledgeable purchasers . . . . Public advertising of the offerings would, of course, be incompatible with a claim of a private offering.[7]

This interpreration of the private offering exemption has remained essentially unchanged for the last 45 years.

The Commission now attempts to walk a fine line in this proposal by seeking to allow public announcements in connection with unlimited, unregistered securities offerings, yet not disturb its

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[6] *See* Non-Public Offering Exemption, SEC Rel. No. 33-4552 (Nov. 6, 1962).

[7] *Id.* at text preceding n.2, text preceding n.3 (emphasis added).

longstanding interpretation of the "no public offering" exemption in Section 4(2). It attempts to do so by promulgating Rule 507 pursuant to its general exemptive authority in Section 28 of the Securities Act, which would permit adoption of the rule upon a finding by the Commission that Rule 507 is "necessary or appropriate in the public interest and consistent with the protection of investors."[8] This procedural posture cannot hide the fact that the Commission's proposal would erode the critical distinction between public and private securities offerings. In effect, the Commission is attempting to do indirectly what it prefers not to do directly – to provide an exemption from Securities Act registration that is at odds with the Commission's own longstanding position under Section 4(2).

This approach strikes us as highly problematic, on both legal and policy grounds. First, the Commission has analyzed whether proposed Rule 507 meets the Section 28 standard for exemption by reference to the standard articulated in *Ralston Purina*, the seminal Supreme Court case interpreting Section 4(2).[9] Incorporating the Section 4(2) standard into Rule 507 – and at the same time expressing the desire not to disturb the Commission's historical position – would seem to invite years of difficult interpretations of Section 4(2), which has been one of the critical underpinnings of the distinction between "public" and "private" offerings since passage of the Securities Act.

It also is a first step down a very slippery slope. By allowing announcements of what should be private securities offerings to be published in print media and on the Internet, the Commission would take a large and fateful first step down a regulatory path toward a "public offer, private sale" regime.[10] If such a regime came to pass, regulatory protections for unregistered offerings of securities would focus solely on persons who ultimately *purchase* those securities. This would appear to be fundamentally at odds with the statutory scheme crafted by Congress in 1933, which has as a central premise that *offers* are worthy of regulation, and regulating after the fact provides insufficient safeguards for the American public. The Institute thus views the adoption of Rule 507 as a treacherous path that, once embarked upon, will over time erode the important investor protection provisions and safeguards intended by the Securities Act.

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[8] "Because some advertising would be permitted in Rule 507 transactions, we have chosen not to propose the exemption under Section 4(2) of the Securities Act, which the Commission in the past has viewed as incompatible with a non-public offering under Section 4(2)." Proposing Release at n.75.

[9] *See* Proposing Release at n.74 ("The conclusion that investors do not need all the protections that registration under the Securities Act would offer them and that they can fend for themselves is the determination that must be made under *SEC v. Ralston Purina*, 346 U.S. 119, 125 (1953), to establish that transactions are exempt under Section 4(2) of the Securities Act as transactions 'not involving any public offering.' We believe the *Ralston Purina* standard is informative in analyzing whether Rule 507, as proposed, would satisfy the Section 28 standard.").

[10] The Commission has received specific requests for regulatory reform that would effectively create a "public offer, private sale" regime. *See, e.g.*, Letter from Keith Higgins, Chair, Committee on Federal Regulation of Securities, American Bar Association, to John W. White, Director, Division of Corporation Finance, Securities and Exchange Commission, dated March 22, 2007 (recommending comprehensive reform of private securities offerings).

2. **The Commission Has Failed to Demonstrate that the Limited Announcement Provision of Rule 507 is "Necessary or Appropriate in the Public Interest and Consistent with the Protection of Investors," as Required by Section 28 of the Securities Act**

No Showing that Rule 507 Advertisements are Necessary or Appropriate in the Public Interest

The Proposing Release contains little discussion as to why the Commission believes that tombstone-like advertisements of unlimited, unregistered securities offerings are necessary. There is no suggestion in the Proposing Release, for example, that private issuers of securities are unable to find potential investors using existing means, or that issuers have inordinate difficulty in complying with the prohibition on general solicitation and general advertising. It also would seem difficult to conclude that Rule 507 advertisements are necessary when, in fact, the Commission staff has in recent years interpreted the prohibition on general solicitation and general advertising with some flexibility, to take into account the widespread use of the Internet and other changes in communications technology.[11]

The Proposing Release seems to suggest that the limited announcement provision in Rule 507 would be appropriate in the public interest because it is modeled on the public advertising that is permitted today in selected types of securities offerings exempt from registration under the Securities Act and applicable state securities laws. Specifically referenced in the Proposing Release are the limited announcements that are allowed by the Securities Act exemption in Rule 1001 of Regulation CE, which is specific to limited offerings conducted under California's "qualified purchaser exemption."[12] The Proposing Release also indirectly references the limited announcements allowed in limited

[11] *See, e.g.*, IPONET (July 26, 1996) (general solicitation is not present when previously unknown investors are invited to complete a web-based questionnaire, and are provided access to private offerings via a password-protected website only if a broker-dealer makes a determination that the investor is accredited under Regulation D); Lamp Technologies, Inc. (May 29, 1998) (posting of information on a password-protected website about offerings by private investment pools, when access to the website is restricted to accredited investors, would not involve general solicitation or general advertising under Regulation D). These interpretive positions took care to preserve the private offering distinction and its related protections.

[12] *See* Proposing Release at n.61 ("We already have one federal exemption from Securities Act registration that permits offerings involving select investors and a limited amount of general solicitation.").

offerings to accredited investors that are conducted pursuant to Rule 504 of Regulation D and individual state laws.[13]

What the Proposing Release fails to acknowledge explicitly, however, is that the applicable Securities Act exemptions for these limited offerings were promulgated by the Commission under Section 3(b) of the Securities Act, commonly referred to as the "small issue" exemption. Section 3(b) allows the Commission to exempt from the Securities Act any class of securities upon finding that enforcement of the Securities Act with respect to those securities "is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." As recently as 1980, Congress revisited the "small issue" exemption and determined that it was appropriate to set the ceiling for Section 3(b) offerings at $5 million. It is thus reasonable to infer from this action that Congress did not intend for unregistered public offerings to involve an unlimited amount of securities. On this basis, we believe that the limited announcements allowed in Section 3(b) offerings to facilitate access by small issuers to the capital markets bear no reasonable relationship to the question of whether it is appropriate to allow limited public announcements under Rule 507.

No Showing that Rule 507 Advertisements are Consistent with the Protection of Investors

To satisfy the standard for exemption set forth in Section 28 of the Securities Act, the Commission also must demonstrate that the limited public advertising envisioned by Rule 507 is "consistent with the protection of investors." The Proposing Release states that the rule satisfies this standard, in relevant part, because it "impose[s] strict controls on advertising."[14] The Proposing Release further explains that Rule 507 advertisements would be limited to written form "in an effort to limit aggressive selling efforts made through the announcement" and, accordingly, that "radio or television

[13] Rule 504(b)(1)(iii) under Regulation D allows offerings made exclusively according to state law exemptions from registration that permit general solicitation and general advertising provided that sales are made only to accredited investors. This provision of Regulation D is not discussed directly in the Proposing Release. Rather, the Proposing Release focuses on the Model Accredited Investor Exemption approved by the North American Securities Administrators' Association ("NASAA") in 1997, which has served as the template for over 30 state laws that work in conjunction with Rule 504(b)(1)(iii). *See, e.g.*, Letter on behalf of NASAA from Patricia D. Struck, NASAA President and Wisconsin Securities Administrator, to Nancy M. Morris, Federal Advisory Committee Management Officer, Securities and Exchange Commission, dated March 28, 2006, at n.2 (commenting on the draft report by the Advisory Committee on Smaller Public Companies). The Proposing Release states that the limited announcement provision of Rule 507 is "substantially patterned" after the advertising provision contained in the NASAA model exemption. *See* Proposing Release at n.59.

[14] *See* Proposing Release at 26-27.

broadcast spots or 'infomercials' would be prohibited."[15] In this era of technological advances, however, the line between written materials – which have been viewed as including the Internet – and broadcast – which traditionally has had a multi-media component – has been blurred. It is difficult to determine how the Commission could satisfy itself that its intended limitations would, in fact, provide the necessary protections.

The Proposing Release, moreover, tells just half the story, by focusing on what the proposal would not allow. In the Institute's view, it is more important to focus on what the proposal *would* allow – namely, advertisements made broadly available in print media and on the Internet for all to see, announcing unlimited offerings of unregistered securities. Viewed from this perspective, it is clear that the Commission's proposal would have the overall effect of reducing the safeguards that have been in place for more than 45 years to protect the general public from the heightened risks associated with unregistered securities offerings.

Although Rule 507 is presumably intended to make it easier for private issuers to locate eligible investors, the public advertising contemplated for Rule 507 offerings would surely have the effect of stimulating demand for these securities among ineligible investors as well. The Commission clearly recognizes this risk and, in fact, states in the Proposing Release that it attempted to craft the proposed rule "in a manner that is cognizant of the potential harm of offerings by unscrupulous issuers or promorers who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration."[16] In the Institute's view, the potential for this type of harm should, in and of itself, be sufficient reason for the Commission – in accordance with its investor protection mandate – to maintain a strict prohibition on general solicitation and general advertising in unlimited, unregistered securities offerings.

The Commission's proposal would have the unintended, yet entirely foreseeable, effect of making it easier for perpetrators of securities fraud to target and defraud the public. The overall increase in announcements for unregistered securities offerings would make it difficult for investors to distinguish between advertisements for legitimate offerings and advertisements for fraudulent schemes. So too would it complicate the Commission's own compliance and enforcement efforts with regard to unregistered offerings, which remain subject to the antifraud and civil liability provisions of the federal

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[15] *See* Proposing Release at 20. The Proposing Release specifically requests comment on a number of ways in which the proposal might be broadened to allow an even greater degree of advertising by, for example: (1) permitting additional information in the announcement; (2) expanding the proposed 25-word limit on the description of the issuer's business; or (3) allowing radio or television broadcast announcements. *See* Proposing Release at 21-22. Any such modification would appear to conflict with the Commission's stated goal of imposing strict controls on the advertising to be permitted under the rule.

[16] *See* Proposing Release at 11.

securities laws, because the Commission is unlikely to have the requisite level of resources to monitor this proliferation of advertisements in a meaningful way.

Investors lacking in investment sophistication are clearly more vulnerable to fraudulent investment schemes. Last year, NASAA conducted a survey to determine the scope of investment fraud involving seniors. Preliminary results indicate that unregistered securities are among the most pervasive financial products involved in senior investment fraud, accounting for approximately 80% of the senior investment fraud cases in Tennessee and approximately 75% of these cases in California and Maryland.[17] These high numbers suggest that the frauds were specifically targeted to retail investors, who generally would not qualify to invest in legitimate unregistered offerings.

To illuminate further the likelihood of increased fraud, consider the results of the Commission's previous attempt to relax the prohibition on general solicitation and general advertising in unregistered offerings. In 1992, the Commission amended Rule 504 under Regulation D to, among other things, eliminate the manner of sale requirements in the rule and thus expressly permit general solicitation and general adverrising in all Rule 504 offerings.[18] A mere seven years later, the Commission reversed course and largely reinstated the prohibition on general solicitation and general advertising for Rule 504 offerings.[19] The Commission's action was prompted by concern that the flexibility it had built into the rule – including by allowing general solicitation of investors – was "being abused by perpetrators of microcap fraud."[20] Many of the factors that, in the Commission's view, could have exacerbated the opportunities for microcap fraud similarly characterize the conditions that would exist for privately placed securities under proposed Rule 507: unprecedented growth in the capital markets, technological changes (most notably the Internet), and the lack of widely distributed public information about the issuers of the securities.

The Institute firmly believes that the Commission has not provided sufficient justification for a proposal that would effectively diminish existing investor protections with respect to unlimited offerings of unregistered securities. For the reasons outlined above, the Institute strongly urges the Commission to abandon its proposal to allow an easing of the current prohibition on general solicitation and general advertising in connection with such offerings.

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[17] *See* NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of All Complaints Received by State Securities Regulators: Unregistered Securities, Variable and Equity-Indexed Annuities Most Pervasive Financial Products Involved in Senior Investment Fraud (press release by North American Securities Administrators Association, July 17, 2006), available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/4998.cfm.

[18] *See* Small Business Initiatives, SEC Rel. No. 33-6949 (July 30, 1992).

[19] *See* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, SEC Rel. No. 33-7644 (Feb. 25, 1999) (adopting release).

[20] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, SEC Rel. No. 33-7541 (May 28, 1998) (proposing release) at text following n.20.

Private Investment Pools and the Prohibition Against General Solicitation and General Advertising

If the Commission chooses to disregard these concerns about its proposal and adopt Rule 507, the Institute nonetheless urges that it adopt the rule no more broadly than proposed. For compelling legal and policy reasons, the Commission was correct *not* to propose a rule that would allow private investment pools to announce their offerings in widely available public media. Further, in light of the hedge fund industry's repeated calls for greater flexibility to advertise, the Institute urges the Commission to reiterate in its adopting release that general solicitation and general advertising are fundamentally inconsistent with the exclusion of hedge funds and other private investment pools from the registration and regulatory requirements of the Investment Company Act.[21]

Private investment pools are effectively outside the purview of the Investment Company Act by reason of Sections 3(c)(1) and 3(c)(7), which require that the pool is not making or proposing to make a public offer of its securities and that those securities are sold only to certain specific groups of investors. These provisions thus place express statutory limits on both the offer and the sale of securities issued by a private investment pool.

The Commission has stated that the "no public offering" requirement in Sections 3(c)(1) and 3(c)(7) should be interpreted consistently with the non-public offering requirement in Section 4(2) of the Securities Act.[22] Private investment pools thus typically offer their shares in accordance with Rule 506 under Regulation D, the safe harbor provision under Section 4(2), which expressly prohibits any form of general solicitation or general advertising in connection with the offering.

Hedge funds and other private investment pools would not be permitted to rely on Rule 507 as proposed. This decision by the Commission predictably will elicit strong objections from the hedge fund community, which for years has argued for unregistered hedge funds to be able to advertise through the public media while remaining free from the regulatory restrictions and shareholder protections imposed by the Investment Company Act. In February 2002, for example, the hedge fund industry asked the Commission to allow limited advertisements in all offerings pursuant to Regulation D.[23] More recently, the hedge fund industry formally requested that the Commission reconsider its

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[21] The Institute further recommends that the Commission revise the text of Rule 507 so that it expressly excludes private investment pools that would be required to register under the Investment Company Act but for Sections 3(c)(1) and 3(c)(7) of that Act. As proposed, this exclusion would be mentioned in a note at the end of the rule, rather than prominently in the rule text itself. The Institute's recommendation would not change the substance of the rule but should facilitate compliance.

[22] *See* Privately Offered Investment Companies, SEC Rel. No. IC-22597 (April 3, 1997), at n.5.

[23] *See* Letter from John G. Gaine, President, Managed Funds Association, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated Feb. 27, 2002, available at http://www.sec.gov/rules/proposed/s72301/gaine1.htm.

longstanding prohibition on general solicitation and general advertising in private securities offerings.[24] In addition to this push from the hedge fund industry, the Commission staff itself recommended in 2003 that the Commission consider permitting general solicitation in offerings by hedge funds that rely on the exclusion in Section 3(c)(7) of the Investment Company Act.[25] These developments, taken together, suggest that the time is ripe for the Commission to speak to this issue directly.

As a threshold matter, the Commission should make clear in its adopting release that it cannot simply extend proposed Rule 507 – which was promulgated under the Commission's exemptive authority in the Securities Act – to include hedge funds and other private investment pools. In order for private investment pools to advertise, the Commission would have to approve an explicit exemption from the "no public offering" requirement in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. This exemption would have to be promulgated pursuant to the Commission's general exemptive authority under Section 6(c) of the Investment Company Act, which would require the Commission to find that the exemption is "necessary or appropriate in the public interest and consistent with the protection of investors *and the purposes fairly intended by the policy and provisions of [the Investment Company Act]*" (emphasis added). The Institute submits that the Commission could under no circumstances make the required finding because, as explained below, any form of general solicitation or general advertising by hedge funds and other private investment pools is directly contrary to Congressional intent and would raise serious investor protection concerns.

1. General Solicitation or General Advertising by Private Investment Pools is Contrary to Congressional Intent

Allowing hedge funds and other private investment pools organized pursuant to Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to advertise publicly would contravene the clear intent of Congress in adopting those provisions. Section 3(c)(7) in particular was added to the Investment Company Act just a decade ago, in apparent recognition that the full panoply of investment company regulation is not necessary for private investment pools that are offered and sold only to financially sophisticated investors able to bear the risk of loss associated with investing in a private pool. In adopting Section 3(c)(7), Congress set forth only two criteria for these private investment pools: that they be sold only to "qualified purchasers," and that they not be permitted to make a public offering of securities. In so doing, Congress generally tracked the language in Section 4(2) of the Securities Act, which the Commission has long interpreted as inconsistent with public advertising.

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[24] *See* Letter from John G. Gaine, President, Managed Funds Association, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated July 5, 2007, available at http://www.managedfunds.org/downloads/MFA_comments_reg_agenda%20July%205th,%202007.pdf.

[25] *See* Implications of the Growth of Hedge Funds, Staff Report to the Securities and Exchange Commission (Sept. 2003) ("Hedge Fund Report"), at 100-01.

In its rulemaking to implement Section 3(c)(7) and related provisions, the Commission observed that "while the legislative history ... does not explicitly discuss Section 3(c)(7)'s limitation on public offerings by Section 3(c)(7) funds, the limitation appears to reflect Congress's concerns that unsophisticated individuals not be inadvertently drawn into [such] funds."[26] A member of Congress intimately involved in this debate later concurred with the Commission's interpretation in a letter to then Chairman Arthur Levitt. His letter further explained:

> In 1996, as part of the National Securities Markets Improvement Act, Congress reaffirmed that hedge funds should not be publicly marketed, specifically adding this restriction to a modernized hedge fund exemption that was included in the final bill. As you will recall, I was one of the authors of this provision ... I believe that the Congress has appropriately drawn the lines regarding hedge fund marketing, and intend to strongly oppose any effort to liberalize them.[27]

In response, Chairman Levitt wrote:

> As you point out, the Investment Company Act of 1940 (the "Act") was designed to protect unsophisticated investors from the risks of investing in unregulated investment pools, or, as they are commonly called, hedge funds. To that end, the Act prohibits hedge funds from publicly offering their securities and limits investment in such pools to specific groups of investors. The Commission believes that these prohibitions and limitations are appropriate to protect unsophisticated investors. The Commission is committed to ensuring that these protections are properly enforced.[28]

Allowing Section 3(c)(7) funds to advertise would eviscerate half of the statutory limitations adopted just a decade ago – a result no doubt eagerly desired by hedge fund sponsors. The Institute respectfully suggests that it would be inappropriate for the Commission, through its exemptive authority, to adopt such a sweeping change to the regulatory framework so recently adopted by Congress, given that there have been no sweeping changes in the private pool industry since the adoption of Section 3(c)(7) and nothing to suggest that such investor protections are no longer necessary.

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[26] Privately Offered Investment Companies, SEC Rel. No. IC-22597 (April 3, 1997), at n.5.

[27] Letter from Rep. Edward J. Markey (D-Mass.) to SEC Chairman Arthur Levitt, dated Dec. 18, 2000.

[28] Letter from SEC Chairman Arthur Levitt to Rep. Edward J. Markey (D-Mass.), dated Jan. 29, 2001.

2. **General Solicitation or General Advertising by Private Investment Pools Would Raise Serious Investor Protection Concerns**

Hedge funds are largely unregulated products that may engage in very risky investment strategies, with virtually no required day-to-day safeguards for investors. They are not subject to any substantive regulation and there are no restrictions on who can start a hedge fund. Indeed, with the exception of the antifraud standards – which have been described by a former Commission official as "too little, too late" for defrauded investors[29] – hedge funds are largely free from direct regulation under the federal securities laws. The fact that unregistered hedge funds operate largely outside of regulation designed to protect the markets and the investing public – including but not limited to registration, disclosure, most reporting requirements, specific conflict of interest prohibitions, and investment limitations – makes it imperative that hedge funds continue to be both offered and sold only to investors who are able to "fend for themselves."

The Commission recently has taken important action on the "sale" side of this equation, to provide additional protections around who may invest in hedge funds and other private investment pools organized under Section 3(c)(1) of the Investment Company Act. Specifically, the Commission has proposed that natural persons satisfy an additional test to be eligible to invest in a Section 3(c)(1) pool. In addition to demonstrating that he or she has sufficient net worth or income, as is now required, an investor in a Section 3(c)(1) pool also would be required to own at least $2.5 million in investments. According to the Commission's proposing release, this new two-step approach would mirror the existing eligibility requirements for investors in hedge funds and other private investment pools organized under Section 3(c)(7). In discussing the need for this additional level of protection, the Commission explained that private investment pools:

> ... involve risks not generally associated with many other issuers of securities. Not only do private [investment] pools often use complicated strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities

[29] As observed by Paul Roye, then Director of the Commission's Division of Investment Management, "By the time we find out about [an instance of hedge fund fraud], it's too late. The money's gone." *See* "Roye Indicates Interest in Finding Way to Inspect More of Nation's Hedge Funds," BNA 33 Sec. Reg. & L. Rep. (BNA) 1678 (Dec. 3, 2001). According to the article, Roye further observed that Commission staff may not inspect the books and records of hedge funds whose advisers are not registered with the Commission, thus making it difficult to determine whether a hedge fund is violating the antifraud rules.

> registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures, and the higher risk that may accompany such pools' anticipated returns.[30]

The Institute strongly supports this proposal, which would help to ensure that sales of hedge funds and other private investment pools are made only to those investors who have the requisite level of knowledge and financial sophistication and the ability to bear the economic risk of their investment.[31]

Having recognized the heightened risks associated with private pool investments, the Commission should likewise take steps on the "offer" side of the equation, by continuing to ensure that interests in hedge funds and other private investment pools cannot be marketed generally to the public. As indicated by the Commission's experience in attempting to allow general solicitation and general advertising in Rule 504 offerings – and then having to reverse course in the face of increased fraudulent activity[32] – it is entirely foreseeable that any easing of the current prohibition on general solicitation and general advertising in hedge fund offerings would invite more hedge fund fraud, to the detriment of investors and the markets generally. Moreover, as the Commission recently acknowledged, the agency faces continued limitations on its "ability to deter or detect fraud by unregistered hedge fund advisers. We currently rely almost entirely on enforcement actions brought after fraud has occurred and investor assets are gone."[33] This frank assessment suggests that the Commission would be well advised to make full use of the existing tools in its arsenal to limit opportunities for hedge fund fraud *before* it occurs.

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[30] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. Nos. 33-8766 and IA-2576 (Dec. 27, 2006) at text following n.45. A similar concern was voiced by the Commission staff in 2003, when it observed that "even [investors] meeting the accredited investor standard . . . may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision." *See* Hedge Fund Report, supra note 25, at 81.

[31] *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated March 9, 2007 at 2, available at http://www.sec.gov/comments/s7-25-06/s72506-565.pdf.

[32] *See supra* notes 18-20 and accompanying text.

[33] Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2333 (Dec. 2, 2004) at text preceding n.60. In the course of that rulemaking, the Commission further observed:

> Unregistered hedge fund advisers operate largely in the shadows, with little oversight, are subject to the pressures of performance fee arrangements, and in many cases are expected to generate positive returns even in down markets. While these conditions can stimulate a tremendous amount of investment creativity and profit, they are also a perfect medium for the germination and growth of frauds. As we have seen, hedge fund advisers are capable of serious transgressions that can harm ordinary citizens who in many cases are now their ultimate beneficiaries.

Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Rel. No. IA-2266 (July 20, 2004) at text accompanying n.64.

One of these tools is continuing to maintain a strict line on prohibiting any form of general solicitation or general advertising – no matter how limited in scope – in connection with hedge fund offerings.

Further, permitting hedge funds and other private investment pools to advertise through media intended to reach a broad public audience, such as newspapers and the Internet, would invariably cause confusion – both for investors and for the marketplace – between registered, highly regulated investment companies and unregistered, largely unregulated private pools. This confusion is likely to exacerbate already imprecise uses of "fund" and "money market fund" to refer to investment pools, whether registered or not.[34] Trouble in the hedge fund area that bleeds over in the public's mind to include mutual funds could shake public confidence in those regulated products, which serve as the primary investment vehicle for over half of all U.S. households.

Adjustments to Accredited Investor and Accredited Natural Person Standards

The Commission proposes to adjust for inflation – on a going forward basis – all dollar-amount thresholds in the accredited investor standards of Rule 501 under Regulation D and in the definition of "accredited natural person" in proposed Rule 509 of Regulation D. As proposed, these adjustments would occur at five-year intervals beginning in July 2012 and would reflect changes in the value of a widely-used index that tracks consumer prices. The Institute strongly supports the Commission's stated goal of "adjusting the thresholds for inflation in the future . . . [in order to] retain the income, assets, and investments requirements in real terms so that the accredited investor standards will not erode over time."[35] We believe that the Commission's proposal, however, would fall short of achieving this goal, because simply adjusting the dollar thresholds to account for consumer price inflation would not sufficiently protect against erosion of these thresholds due to wage inflation or asset appreciation, both of which have historically outpaced increases in consumer prices.

A better approach, in the Institute's view, would be to require the Commission's Office of Economic Analysis ("OEA") to reset the thresholds every five years so that the percentage of the population qualifying as accredited investors or accredited natural persons would remain stable over time. This would entail a straightforward economic analysis that could be performed using widely available government databases. OEA performed this same type of analysis, based upon data from the Federal Reserve Board's Survey of Consumer Finances, in connection with defining the thresholds for the "large accredited investor" standard. As the Proposing Release indicates, those thresholds were chosen so as to approximate – in today's dollars – the standards that were set by the Commission in 1982 for accredited investors.[36]

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[34] *See, e.g.*, "False Media Reports Roil Money Market Funds," IGNITES (Aug. 15, 2007) (describing how press reports that erroneously identified an unregistered cash management pool as a money market mutual fund sparked selling in three major indexes, after the unregistered pool halted redemptions).

[35] *See* Proposing Release at 43.

[36] *See* Proposing Release at nn. 50-51 and accompanying text.

The Institute believes, moreover, that the Commission's proposal would not go far enough, because it would make no adjustment to the accredited investor standards in Rule 501 to correct for the substantial erosion that has occurred during the period from 1982, when the standards were adopted, to the present day. This is despite the express acknowledgement in the Proposing Release that "inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the 'accredited investor' standard. By not adjusting these dollar-amount thresholds upward for inflation, we have effectively lowered the thresholds . . . ."[37] On this basis, the Institute strongly urges the Commission to make an immediate, one-time adjustment to the dollar thresholds that would correct for this erosion.[38] Such a one-time adjustment, coupled with the periodic future adjustments discussed above, would help to ensure that participation in private securities offerings under Regulation D is available only to financially sophisticated investors who are able to bear the economic risk of their investment.[39]

* * * *

[37] *See* Proposing Release at 42 (citation omitted).

[38] The Commission has expressed its reluctance to make an immediate upward adjustment, out of concern that raising the accredited investor standards too high may cause some issuers to conduct private offerings outside the Regulation D safe harbor. *See* Proposing Release at 42-43. We are not persuaded that this generalized concern should outweigh the very real dangers posed by a failure to maintain high investor qualification standards for most private offerings, which *are* conducted in accordance with Regulation D. As the Proposing Release indicates, issuers have good cause for choosing to comply with Regulation D, including the ability to avoid the "expenses and complications of multi-state securities law compliance and the uncertainty of case law interpretations of the Section 4(2) exemption." Proposing Release at 42.

[39] The Institute recognizes that this recommendation effectively would result in parity between the dollar thresholds in the accredited investor standards, on the one hand, and the proposed standard for "large accredited investors," on the other hand. If the Commission determines to adopt a "large accredited investor" standard, it should do so with higher dollar thresholds, so as to avoid this result.

The Institute appreciates the opportunity to comment on the Commission's proposed amendments to Regulation D. If you have any questions about our comments or would like additional information, please contact me at 202/326-5901 or Karrie McMillan, General Counsel of the Institute, at 202/326-5815.

Sincerely,

/s/

Paul Schott Stevens
President and CEO

cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

John W. White, Director
Division of Corporation Finance

Andrew J. Donohue, Director
Elizabeth G. Osterman, Assistant Chief Counsel
Division of Investment Management

About the Investment Company Institute

ICI members include 8,889 open-end investment companies (mutual funds), 675 closed-end investment companies, 471exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $11.339 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households. In addition, the ICI's membership includes 141 associate members, which render investment management services exclusively to non-investment company clients.

EXHIBIT 7

Professor Jay Brown

And Need to Extend Bad Actor Provisions

UNIVERSITY OF
DENVER
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Legal Research Paper Series

Working Paper No. 11-30

Seed Capital, Rule 504 and the Applicability of Bad Actor Provisions

J. Robert Brown, Jr.

University of Denver Sturm College of Law

UNIVERSITY OF
DENVER
STURM COLLEGE OF LAW

Via e-mail to **rule-comments@sec.gov**

February 1, 2012

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Securities Act Release No. 9211 (May 25, 2011); File No. S7-21-11

Ladies & Gentlemen:

Securities Act Release No. 9211 (May 25, 2011) sought comments on rule proposals designed to implement Section 926 of Dodd-Frank by extending badgirl provisions to transactions exempt under Rule 506 of Regulation D. In addition, however, the Release asked whether the bad actor provisions should be extended to Rule 504, the seed capital exemption.

Extending the bad actor provisions to Rule 504 is an appropriate reform. Nonetheless, the Commission should not merely insert the proposed bad actor provisions into the Rule. Instead, the Commission should take into account the unique attributes of Rule 504 and craft provisions that are more appropriately designed to reduce its use by recidivists.

I. Rule 504: Capital Raising v. Securities Fraud

The proposing release notes that most offerings under Regulation D rely on Rule 506.[1] While Rule 504 may not be used as often, the seed capital exemption plays a significant role in violations of Section 5 of the Securities Act, particularly those involving microcap companies.[2] This is not news. The SEC has long had concern over the role of Rule 504 in registration violations.[3]

[1] Securities Act Release No. 9211, at 4 (May 25, 2011) ("It is by far the most widely used Regulation D exemption, accounting for an estimated 90-95% of all Regulation D offerings and the overwhelming majority of capital raised in transactions under Regulation D. ").
[2] For recent enforcement actions mentioning Rule 504, *see* Appendix to this Memorandum.
[3] *See* Revisions of Limited Offering Exemptions in Regulation D, Exchange Act Release No. 8828, at 73 (Aug. 3, 2007) ("The Commission had been concerned for some time with abusive practices in Rule 504 offerings, many of

These types of violations often involve repeat players. Indeed, recidivism is a general concern under the federal securities laws. *See* Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 Penn St L. Rev. 189 (Summer 2008). President Obama in his State of the Union speech[4] and Chairwoman Schapiro in a recent submission to Congress[5] noted the problem of repeat offenders under the securities laws.

One way to reduce the use of Rule 504 by recidivists is to eliminate some of the attributes that make the provision appealing to bad actors. Rule 504 is the only exemption in Regulation D that permits general solicitations and freely transferable shares.[6] Eliminating one or both of these attributes might reduce the instances of microcap fraud but would also have the collateral consequence of making the Rule less attractive to legitimate companies seeking to raise seed capital.

Applying a carefully crafted bad actor provision to Rule 504 represents an alternative approach to reducing microcap fraud. It targets only recidivists and imposes minimal additional burdens on legitimate businesses.[7] At the same time, the Commission should not simply opt for uniform application of the disqualifications contained in Regulation A but should reconsider the categories of covered persons and the applicable offenses in light of the goal of reducing use by recidivists.

II. Expanding the Types of Covered Persons and Disqualifying Events

A. Covered Persons

Microcap fraud, particularly pump and dumps, generally requires an issuer, large shareholders ready to sell significant blocks of stock, and brokers that execute the trades.[8] The bad actor provisions in Rule 262 and the proposals with respect to Rule 506 for the most part

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which involved "pump and dump" schemes for securities of non-reporting companies that traded over the counter."); Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, at 1 (Feb. 25, 1999) ("Unfortunately, there have been recent disturbing developments in the secondary markets for some securities initially issued under Rule 504, and to a lesser degree, in the initial Rule 504 issuances themselves.").

[4] *See* President Barak Obama, State of the Union Address (Jan. 25, 2012 ("Some financial firms violate major anti-fraud laws because there's no real penalty for being a repeat offender. That's bad for consumers, and it's bad for the vast majority of bankers and financial service professionals who do the right thing."), *available at* http://www.nytimes.com/interactive/2012/01/24/us/politics/state-of-the-union-2012-video-transcript.html

[5] *See* Letter from Mary Schapiro, Chair, Securities and Exchange Commission to Jack Reed, Chairman, Subcommittee on Securities, Insurance and Investment, Committee on Banking, Housing and Urban Affairs, US Senate, Nov. 28, 2011 (seeking authority designed to "explicitly increase the cost of repeat offenses"), *available at* http://www.nabl.org/uploads/cms/documents/MaryShapiroLetter.pdf

[6] Companies may only do so only if the offering meets certain requirements under state law. *See* Rule 504(b)(1), 17 CFR 230.504(b)(1).

[7] Issuers would likely incur modest cost in exercising some level of due diligence designed to ensure that there were no bad actors involved in the offering.

[8] This is not to say that all of the participants violate the law. An issuer could properly place shares, with the pump and dump occurring thereafter. Similarly, brokers placing orders may have no culpability with respect to the illegal transaction.

include these persons.[9] There are, however, two additional categories that are sometimes implicated in these transactions: lawyers and transfer agents.

To effectively execute most pump and dumps, the selling shareholders must have a large inventory of what appears to be freely transferable shares. This generally means shares that purport to be free from limitations on resale and therefore do not bear restrictive legends on the certificate. Rule 504 is the only exemption in Regulation D that permits the issuance of shares without a restrictive legend. Before providing certificates in offerings under Rule 504, however, the transfer agent commonly requires an opinion of counsel[10] opining that the shares are freely transferable and the certificates need not bear a restrictive legend.[11]

The Commission has, in some cases, raised concern about problematic opinion letters from lawyers under Rule 504. *See SEC v. Gendarme Capital Corp.*, 2011 SEC Lexis 211, at 15 (Jan. 6, 2011); *SEC v. Luna*, Litigation Release No. 21779, at 1 (Dec. 15, 2010); *SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676, at 1 (D. Ariz. Aug. 8, 2008); *In re Christison*, Securities Act Release No. 8892, at 2 (admin proc Feb. 7, 2008). Similarly, the Commission has expressed concern with "improper" removal of legends by transfer agents. *See In re Holladay Stock Transfer Inc.*, Securities Act Release No. 7519 (admin proc Mar. 25, 1998).

Including lawyers and transfer agents in the category of covered persons would make the improper use of Rule 504 more difficult. Moreover, in many respects the approach would reaffirm existing practices by the Commission. The Commission has sometimes sought to bar lawyers from writing additional opinion letters. *See SEC v. Allixon International Corp.*, Litigation Release No. 19987 (ND Tex. Feb. 1, 2007); *see also Complaint, SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676 (D. Ariz. Aug. 8, 2008).[12] The inclusion of lawyers would amount to a de facto ban on writing additional opinion letters in exempt offerings.

The concern over the role of lawyers is not alleviated by the Commission's authority under Rule 102(e). Attorneys are occasionally barred or suspended from practice before the Commission as a result of an alleged role in unregistered offerings. Not all lawyers involved in registration violations are, however, subjected to proceedings under Rule 102(e). More to the point, even those sanctioned may not be prevented from writing additional opinion letters. The opinion letters are not filed with the Commission and therefore arguably fall outside of the

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[9] In addition to issuers and their affiliates, the proposed bad actor provisions would extend to "any beneficial owner of 10% or more of any class of the issuer's equity securities; any promoter connected with the issuer in any capacity at the time of such sale: any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor". Proposed Rule 506(c)(1).

[10] This does not mean that letters always came from lawyers. *See SEC v. Spongetech Delivery Systems, Inc.*, Litigation Release No. 21515 (ED NY May 5, 2010) (allegations that "false and misleading attorney opinion letters" were issued "in the name of a fictitious lawyer").

[11] *See In re Weeks*, Initial Decisions Release No. 199 (admin proc Feb. 4, 2002) ("It would have been difficult for an issuer to effectuate the distribution of a massive amount of unregistered securities without help from an accommodating transfer agent.").

[12] The complaint is available at http://www.sec.gov/litigation/complaints/2008/comp20676.pdf

definition of "practice before the Commission." *See* Rule 102(f) (defining practice to include the preparation of any opinion "filed with the Commission.").[13]

The inclusion of transfer agents as a covered person may have broad consequences. A transfer agent that is disqualified as a bad actor will presumably suffer a loss of business. At least some companies will likely be unwilling to remain with a transfer agent that cannot participate in exempt offerings under Rule 504. On the other hand, the possibility may well provide transfer agents with an incentive to increase their due diligence[14] when issuing stock certificates in exempt offerings.[15]

B. Expanding the Category of Disqualifying Events

The bad actor provisions also define the events that result in disqualification. These include court injunctions that prohibit the covered party from "engaging in or continuing any conduct or practice in connection with the purchase or sale of securities or involving the making of a false filing with the Commission." This presumably includes covered persons who are enjoined from violating Section 5.

Disqualifying events currently do not extend to cease and desist orders issued by the Commission. The Release has sought comment on whether cease and desist orders involving violations of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct should be included. This is an appropriate reform that should be implemented.

The proposal may, however, need to go further. It does not encompass those orders that, while free of allegations of fraud, do assert violations of Section 5. Occasionally such orders have been issued against lawyers. Consideration should be given, therefore, to including as a disqualifying event those cease and desist orders that involve opinion letters causing a violation of Section 5.[16]

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[13] This may well be a disputed point. Nonetheless, the argument is there and because the opinions are not filed, the Commission will usually be unaware of the practice. Barring a lawyer from practicing before the Commission does not, therefore, guarantee that he or she will cease writing problematic opinion letters concerning the applicability of an exemption from registration.

[14] *Compare In re World Trade Financial Corp.*, Exchange Act Release no. 66114 (admin proc Jan. 6, 2012) (transfer agent that removed restrictive legends "did not consider itself responsible for conducting any due diligence on Applicants' behalf, and there was no evidence it conducted the necessary inquiry.") *with SEC v. Marshall*, Litigation Release No. 5709 (CD CA Jan. 24, 1973) ("The transfer agent has an independent duty to exercise good faith and due diligence and therefore cannot base its action or inaction upon instructions of the issuer unless upon the same facts the issuer itself could successfully defend.").

[15] *See In re Holladay Stock Transfer Inc.*, Securities Act Release No. 7519 (admin proc March 25, 1998) (undertakings that required transfer agent to implement "procedures as are deemed reasonable and necessary for the issuance of stock certificates without restrictive legends and the removal of such legends from outstanding shares of stock").

[16] This would presumably include opinions involving other exemptions from registration that cause violations of Section 5, particularly Rule 144. *See* Rule 144: Selling Restricted and Control Securities ("Only a transfer agent can remove a restrictive legend. But the transfer agent won't remove the legend unless you've obtained the consent of the issuer—usually in the form of an opinion letter from the issuer's counsel—that the restricted legend can be removed."), *available at* http://www.sec.gov/investor/pubs/rule144.htm.

III. Conclusion

Application of the bad actor provisions to Rule 504 has the potential to reduce fraud without limiting the usefulness of the Rule to legitimate businesses seeking to raise seed capital. For this to be accomplished, however, the Commission should redraft the bad actor provisions to ensure that they fully limit improper use of the seed capital rule by recidivists.

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Cases over the last 10 years involving the use of Rule 504[17]

1. *SEC v. ConnectAJet.com, Inc.*, Litigation Release No. 22155, 2011 SEC LEXIS 4028 (N.D. Tex. Nov. 15, 2011)

2. *In re Bloomfield*, Initial Decision Release No. 416-A (admin. proc. Apr. 26, 2011) (pump and dump)

3. *SEC v. Gendarme Capital Corp.*, 2011 SEC Lexis 211 (Jan. 6, 2011)

4. *SEC v. Luna*, Litigation Release No. 21779 (Dec. 15, 2010)

5. *In re Briner*, Exchange Act Release No. 63371 (admin. proc. Nov. 24, 2010)

6. *In re Haque*, Securities Act Release No. 9155 (admin. proc. Nov. 1, 2010) (pump and dump)

7. *SEC v. Czarnik*, Litigation Release No. 21401 (S.D.N.Y. Feb. 2, 2010) (pump and dump)

8. *In re Newbridge Sec. Corp.*, Initial Decision Release No. 380 (admin. proc. June 9, 2009) (pump and dump)

9. *In re Stocker*, Exchange Act Release No. 60016 (admin. proc. June 1, 2009)

10. *SEC v. Alliance Transcription Services, Inc.*, Litigation Release No. 20676 (D. Ariz. Aug. 8, 2008)

11. *SEC v. Homeland Safety Int'l*, Litigation Release No. 20645 (N.D. Okla. July 15, 2008) (pump and dump)

12. *In re Allixon Int'l Corp.*, Securities Act Release No. 8925 (admin. proc. June 2, 2008)

13. *In re Alt. Energy Tech. Ctr., Inc.*, Exchange Act Release No. 57600 (admin. proc. Apr. 2, 2008)

14. *In re Christison*, Securities Act Release No. 8892 (admin. proc. Feb. 7, 2008)

15. *In re Carley*, Securities Act Release No. 8888 (admin. proc. Jan. 31, 2008)

16. *In re Disraeli & Lifeplan Associates*, Securities Act Release No. 8880 (admin. proc. Dec. 21, 2007)

[17] The listed cases are from a search of Lexis Nexis over a ten year period. These are cases that explicitly mention Rule 504. The list probably represents an undercount of cases involving the Rule. Many actions brought by the Commission that allege violations refer to Section 5 do not specify the particular exemption or safe barbor that was improperly relied upon in the offering. Some of them probably involve Rule 504.

17. *SEC v. Offill*, Litigation Release No. 20302 (N.D. Tex. Sept. 27, 2007)

18. *In re Disraeli*, Initial Decision Release No. 328 (admin. proc. Mar. 5, 2007)

19. *SEC v. Allixon Int'l*, Litigation Release No. 19987 (N.D. Tex Feb. 1, 2007); Litigation Release No. 19471 (N.D. Tex. Nov. 18, 2005)

20. *In re Temple Sec.*, Securities Act Release No. 8779 (admin, proc. Feb. 1, 2007)

21. *SEC v. Wind Farming, Inc.*, Litigation Release No. 19618 (N.D. Ill. Mar. 21, 2006); Litigation Release No. 19546 (N.D. Ill. Jan. 30, 2006)

22. *In re Harris*, Exchange Act Release No. 53122 (admin. proc. Jan. 13, 2006)

23. *SEC v. Integrated Services Grp. Inc.*, Litigation Release No. 19476 (admin. proc. Nov. 29, 2005) (pump and dump)

24. *In re Allixon Int'l Corp.*, 2005 SEC LEXIS 2973 (admin. proc. Nov. 17, 2005)

25. *In re Carley*, Initial Release No. 292 (admin. proc. July 18, 2005)

26. *SEC v. Bio-Heal Laboratories, Inc.*, Litigation Release No. 19203 (admin. proc. Apr. 27, 2005)

27. *In re Dorfman*, Securities Act Release No. 8562 (admin. proc. Mar. 31, 2005)

28. *SEC v. Custom Designed Compressor Sys. Inc.*, Litigation Release No. 19101 (admin. proc. Feb. 28, 2005)

29. *In re Nnebe*, Initial Decision No. 269 (admin. proc. Jan. 5, 2005)

30. *In re Oliver*, Exchange Act Release No. 50565 (admin. proc. Oct. 20, 2004) (pump and dump)

31. *In re Smith*, Exchange Act Release No. 50566 (admin. proc. Oct. 20, 2004) (pump and dump)

32. *In re Shapiro*, Exchange Act Release No. 47848 (admin. proc. May 14, 2003)

33. *In re Danilovich*, Exchange Act Release No. 47844 (admin. proc. May 14, 2003)

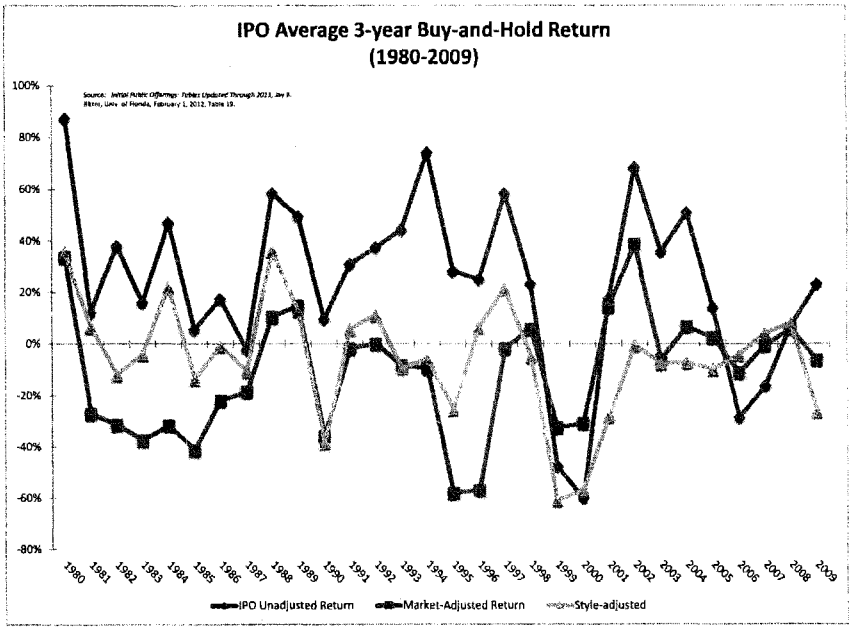
34. *In re Marvul*, Exchange Act Release No. 47846 (admin. proc. May 14, 2003)

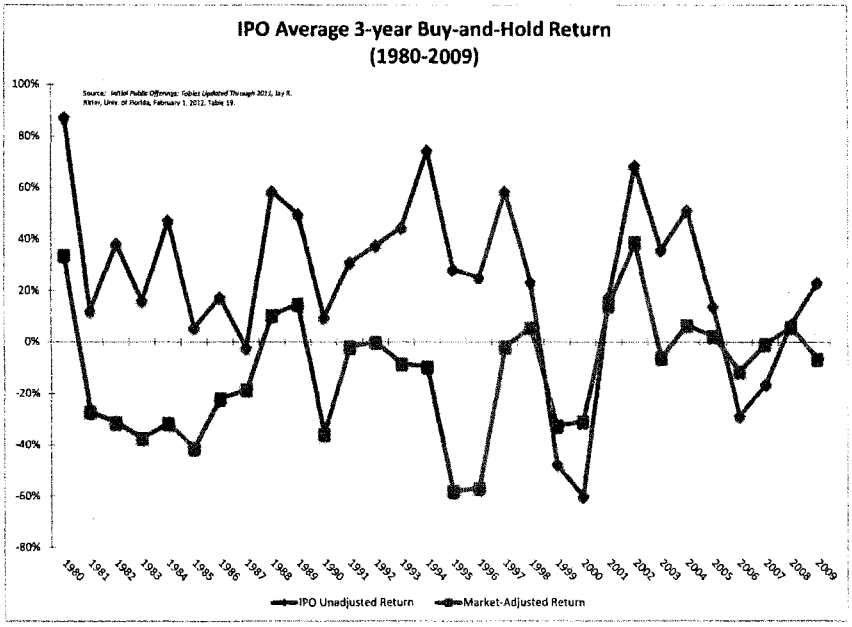
35. *In re Montelbano*, Exchange Act Release No. 472227 (admin. proc. Jan. 22, 2003)

36. *In re Burstein*, Exchange Act Release No. 45715 & 45716 (admin. proc. Apr. 9, 2002)

EXHIBIT 8

Below Market Returns Earned on IPO's


IPO Average 3-year Buy-and-Hold Return
(1980-2009)
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
-80%
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
IPO Unadjusted Return
Market-Adjusted Return
Style-adjusted


IPO Average 3-year Buy-and-Hold Return
(1980-2009)
Source: Initial Public Offerings: Tables Updated Through 2011, by R. Ritter, Univ. of Florida, February 1, 2012, Table 19.
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
-80%
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
IPO Unadjusted Return
Market-Adjusted Return

IPO Performance
Initial Public Offerings: Tables Updated Through 2011 - Jay R. Ritter
Table 19 - Number of IPOs, First-day Returns, and Long Run Performance, IPOs from 1980-2009

	Number of IPOs			IPO Average 3-year Buy-and-Hold Return
Year	Market	Style	Average First-Day Return	IPO Unadjusted Return
1980	73	73	13.87%	87.30%
1981	196	196	6.24%	12.20%
1982	79	79	10.70%	38.20%
1983	449	449	9.98%	16.10%
1984	177	177	3.23%	47.20%
1985	183	183	6.27%	5.60%
1986	396	396	6.09%	17.50%
1987	283	283	5.66%	-2.20%
1988	102	102	5.66%	58.50%
1989	113	113	8.18%	49.60%
1990	110	110	10.82%	9.70%
1991	287	287	11.86%	31.10%
1992	411	411	10.28%	37.60%
1993	508	508	12.76%	44.50%
1994	403	403	9.79%	74.30%
1995	457	457	21.22%	28.40%
1996	675	675	17.19%	25.20%
1997	472	472	14.00%	58.50%
1998	283	283	21.72%	23.50%
1999	476	476	71.01%	-47.80%
2000	380	380	56.44%	-60.10%
2001	79	79	14.18%	17.80%
2002	66	66	9.06%	68.60%
2003	62	62	12.13%	36.10%
2004	174	174	12.29%	51.20%
2005	160	160	10.24%	14.20%
2006	157	157	12.14%	-28.80%
2007	160	160	13.93%	-16.30%
2008	21	21	6.37%	7.10%
2009	41	41	9.85%	23.50%

1980-1989	2,051	2,051	7.20%	22.60%
1990-1994	1,719	1,719	11.20%	45.40%
1995-1998	1,887	1,887	18.00%	34.10%
1999-2000	856	856	64.50%	-53.30%
2001-2009	920	920	11.90%	14.50%
1980-2009	7,433	7,433	18.10%	21.00%

Notes:

[1] Table 19 is an updated Table of Ritter and Welch 2002 Journal of Finance article.

Source: *Initial Public Offerings: Tables Updated Through 2011*, Table 19
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1-Feb-12

Other Notes:

The equally weighted (EW) average first-day return is measured from the offer price to the first CRSP-listed closing price. **EW average three-year buy-and-hold percentage returns** (capital gains plus dividends) are calculated from the first closing market price to the earlier of the three-year anniversary price, the delisting price, or December 31, 2010. Buy-and-hold returns for initial public offerings (IPOs) occurring after Dec. 31, 2009 are not calculated. **Market-adjusted returns** are calculated as the buy-and-hold return on an IPO minus the compounded daily return on the CRSP value-weighted index of Amex, Nasdaq, and NYSE firms. **Style-adjusted buy-and-hold returns** are calculated as the difference between the return on an IPO and a style-matched firm. For each IPO, a non-IPO matching firm that has been CRSP-listed for at least five years with the closest market capitalization and book-to-market ratio as the IPO is used. If this is delisted prior to the IPO return's ending date, or if it conducts a follow-on stock offering, a replacement matching firm is spliced in on a point-forward basis. For 48 IPOs the style-adjusted returns are missing and replaced with the market-adjusted returns. **IPOs with an offer price below $5.00 per share, unit offers, REITs, closed-end funds, banks and S&Ls, ADRs, and IPOs not listed on CRSP within six months of issuing have been excluded. Data is from Thomson Financial**

Securities Data, with supplements from Dealogic and other sources, and corrections by the authors. The number of IPOs per year is much lower than in the 1995 Journal of Finance article "The New Issues Puzzle" by Loughran and Ritter because that paper used a $1.00 offer price screen. The number is larger than in the 2002 Journal of Finance article "A Review of IPO Activity, Pricing, and Allocations" due to various data corrections and the back-filling of Nasdaq-listed foreign issuers by CRSP.

Updated Table of Ritter and Welch 2002 Journal of Finance article

Sarbanes-Oxley and Public Reporting on Internal Control:
Hasty Reaction or Delayed Action

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**Sarbanes-Oxley and Public Reporting on Internal Control:
Hasty Reaction or Delayed Action**

ABSTRACT

Since its passage, the Sarbanes-Oxley Act of 2002 has been criticized, and praised, by many on numerous grounds and claims. However, no single provision of this law has come under more attack than the Section 404 which mandates public reporting of internal control effectiveness by an issuer's management as well as its independent auditors. Even after 10 years, the opposition to the Section 404 internal control requirements has continued to the point where the U.S. Congress finally succumbed to the lobbyist pressures and through Section 989G(a) of the Dodd-Frank Wall Street Reform and Consumers Protection Act passed in 2010 permanently exempted the non-accelerated SEC filers from Section 404(b) of the Sarbanes-Oxley Act of 2002. Many of those who oppose the Section 404 requirements rest their claim on grounds that the U.S. Congress acted in haste in mandating the public reporting of internal controls by U.S. listed companies and that the issue was not well-thought out or debated. They also contend that the U.S. Congress acted under pressure because of the public outrage over the bankruptcy filings of Enron and WorldCom. To the contrary, this paper shows that the debate over public reporting of internal control by U.S. public companies is more than six decades old dating back to the McKesson & Robbins fraud. This paper reviews relevant legislative proposals, bills introduced in both the House and the Senate, regulatory efforts by the SEC, and the recommendations of many Commissions set-up by the private-sector to inform the reader how these efforts were the deliberative precursors to what was eventually codified in Section 404 of the Sarbanes-Oxley Act of 2002.

Key words: Internal control, Financial Reporting, Sarbanes-Oxley Act of 2002, Audit of Internal Control, Section 404

Sarbanes-Oxley and Internal Control Reporting Requirements:
Hasty Reaction or Delayed Action

SECTION I: INTRODUCTION

Unlike other laws, the Sarbanes-Oxley Act of 2002 continues to attract much attention even today. Since its passage in July 2002 thousands of pages have been written critically analyzing many of its provisions and their impact on Corporate America and the U.S. capital markets. Langevoort (2006, 949) notes that "immediately after the passage of the Sarbanes-Oxley Act (SOX), much of the commentary was about Congress's scatter-gun approach, firing at so many different targets at once to prompt better corporate financial reporting and disclosure." Realizing that SOX enacted far reaching reforms in a shortest period of time in the legislative history of any law passed since the enactment of the Securities Act of 1933, its critics called it "a hasty, panicked reaction of an electorate looking for an easy fix" (Hamilton 2002, 38). They also declared that by acting "quickly and without a lot of study," Congress has created a law that will have serious "unintended consequences" (Rosenbloom 2006, 1193-94).

Perhaps, no other Section of this Law has attracted as much attention, rebuke and criticism as Section 404. This section which is merely 169 words continues to evoke strong reactions and counterpoints from all capital market participants, regulators and lawmakers alike. Even during the recent financial crisis and the ensuing economic meltdown that began in 2008, Section 404 "Management Assessment of Internal Controls" was viewed as A.W.O.L. and criticized for not detecting and reporting "bad loans" made by the banks. The opposition to the Law and Section 404 continues to brand this legislation as anti-business, a costly mistake and a hastily passed Law that has brought nothing but erosion of the competitive edge long enjoyed by the U.S. capital markets and U.S. businesses by imposing a significant cost burden on them. More specifically, on Section 404, Langevoort (2006, 950) notes that

> "...the vocal criticism is largely reserved for just one piece of the legislation: the internal control requirements found in Section 404, which in some circles has become almost synonymous with SOX itself. Doubts about the costs and benefits and whether the result will be increased de-listings and going private transactions to avoid 404's burdens have made this portion of the Act that has encountered the most political resistance. The tone of these complaints is that 404's requirements are new, radical, and ill-considered."

On the other hand, some observe that these requirements "... may well be the culmination of a century of development of internal control definitions, applications, and procedures by both private and public governmental entities" (Heier, et al. 2003, 1).

This paper will argue to dispel the myth that Section 404 requirements were written in haste and without any forethought by the drafters of the Law. As a matter of fact, Section 404 requirements were proposed in one form or another in the early 1900s. To make our case, we will examine historical events and circumstances surrounding the decades' long debate around public reporting on internal controls both by management and the independent auditor. It is hoped that our review and interpretation of these historical developments will contribute to the understanding that Section 404 requirements are, in fact, a culmination of decades of debate and deliberations by Congress, regulatory agencies, and the private sector bodies including investor advocacy groups.

The remainder of the paper is divided into eight sections. Section II recounts the charge against SOX and Section 404 in particular. While Section III traces internal control reporting until the 1970s, Section IV analyzes the enactment of the Foreign Corrupt Practices Act of 1977 as a catalyst to SOX internal control reporting requirements. Section V assesses the impact various committees and commissions of the AICPA had on this debate. Section VI analyzes the congressional and the SEC efforts to codify internal control reporting and the obstacles that prevented it from becoming the reality until SOX was passed. While Section VII closes the loop

with enactment of the SOX, Section VIII reviews the continuing debate and Dodd-Frank impact in weakening Section 404(b) requirements. Section IX concludes the paper.

SECTION II: THE CHARGE AGAINST SOX

In the aftermath of Enron and WorldCom financial scandals, on July 30, 2002, President George W. Bush signed into law the most far reaching governance, internal control and disclosure reforms in the history of Corporate America since the enactment of the Securities Acts of 1933 and 1934. Unlike most other laws, the Bill that created the "Public Company Accounting Reform and Investor Protection Act" (a.k.a. Sarbanes-Oxley Act of 2002) passed in the United States Senate by a vote of 99-0 and in the House by a vote of 423-3. In spite of this almost unanimous bipartisan support[1] the Sarbanes-Oxley Act of 2002 and many of its important sections, particularly the management and auditor reporting on internal control provisions, have been vilified from the onset by many lawmakers themselves in Washington, D.C., Corporate America and their lobbyists, and virtually the entire community of "corporate gatekeepers" (i.e., auditors, lawyers, etc.). This opposition reached its pinnacle when in 2006 a small Nevada public accounting firm stunned everyone by filing a lawsuit against the Public Company Accounting Oversight Board (PCAOB) that posed a "stealth" challenge to the constitutionality of the entire Law that eventually was settled by the United States Supreme Court in favor of the supporters of the law (Free Enterprise Fund 2010).

Within less than a year when even many of the Sarbanes-Oxley provisions were not yet fully implemented, Peter J. Wallison, resident fellow at the *American Enterprise Institute for Public*

[1] The Sarbanes-Oxley Act of 2002 represents a reconciliation of the Public Company Accounting Reform and Investor Protection Act of 2002 (S. 2673) which passed the Senate on July 15, 2002, and the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (H.R. 3763) which passed the House of Representatives on April 24, 2002. It also includes provisions from the Corporate Fraud Accountability Act of 2002 (H.R. 5118) which passed the House on July 16, 2002. The Sarbanes-Oxley Act is largely composed of S. 2673. A House-Senate conference to reconcile the House and Senate bills filed a conference report on July 24 2002 (1070610). The Conference Report is essentially the Sarbanes-Oxley Act of 2002. The Senate and House both agreed to the Conference Report on July 25, 2002.

Policy Research (AEI) and a former general counsel of the Treasury and White House Counsel during the Regan administration fired the first shot in an op-ed piece published in the *Financial Times* by proclaiming that "adopted in haste by the Congress and signed by President...the act could turn out to be a classic policy blunder" (Wallison 2003a). He continued his attacks on the Law in an another op-ed piece published this time in the *Wall Street Journal* by alleging that 'Sarbanes-Oxley was adopted hastily and without adequate consideration by a Congress panicked about the possibility that the Enron and WorldCom cases had seriously weakened investor confidence" (Wallison 2003b). Four years later in 2006, in a speech delivered at the Consumer Federation of America, Senator Paul S. Sarbanes (D-MD) recalls these attacks when he notes that an editorial in the Wall Street Journal claimed that "the mad rush to pass Sarbox in 2002 was less about keeping business honest than it was about keeping Congressmen in office"(Sarbanes, 2006).

Interestingly, this belief and attitude on the part of some has not abated even a decade after the passage of the Sarbanes-Oxley Act of 2002. Commenting on the eve of the Supreme Court hearing arguments on the constitutionality of the Sarbanes-Oxley Act of 2002, an op-ed piece under the title of "Sarbanes-Oxley on Trial" appeared in the *Wall Street Journal*. It boasted the bi-line "the hasty 2002 law gets a potent constitutional challenge" and noted that "at stake here isn't merely a poorly written law that has done great economic harm. The issue is whether Congress, in its haste, can ignore the Constitutional order that has ensured accountable government for 230 years" (WSJ 2009). Similarly, two days after the Supreme Court rendered its much awaited opinion, Malloy Factor, former Chairman of the Free Enterprise Fund that brought the lawsuit, reiterated the "hastiness" claim in an op-ed piece in the *Wall Street Journal* when he wrote "But the damage wrought by Sarbanes-Oxley has already been done. Here is the lesson for the future: we

must watch for expensive and painful unintended consequences of laws quickly passed to address public outrage caused by the scandals of the day" (Factor 2010).

Concurrently, the same dissenters were lobbying the U.S. Congress to put pressure on the U.S. Securities and Exchange Commission (SEC) to contain the reach of Section 404 which for the first time requires management reporting on internal control over financial reporting along with auditor assessment and certification of the same in a company's periodic filings. When compared with the rule-making time table for many other SOX provisions, it is noteworthy that the SEC took more than 2 years to issue Final Rules to implement Section 404. This rule required all accelerated filers (An issuer with an aggregate worldwide market value of voting and non-voting common equity of $75 million or more) with year-end on or after November 15, 2004 to file in their periodic reports auditor's independent assessment and certification of a registrant's internal controls over financial reporting. In the ensuing years the resistance to management reporting and auditor certification of a company's internal controls over financial reporting remained a contentious issue with the SEC postponing several times the effective dates of implementing Section 404 for non-accelerated filers (an issuer with market value less than $75 million).

Although, the Supreme Court decision did not grant the wish of the Law's distracters by invalidating the entire Sarbanes-Oxley Act of 2002 due to the absence of the "severability clause", the dissenters nevertheless succeeded in convincing the Congress to grant exemption to the non-accelerated filers from complying with auditor certification of a company's internal controls over financial reporting under Section 404(b). The Section 989G(a) of the "Dodd-Frank" Wall Street Reform and Consumer Protection Act of 2010 permanently exempted the non-accelerated filers from Section 404(b) reporting requirements which require independent auditor certification of a company's internal controls over financial reporting. Supporters of Section 404 (b) are unanimous

in their view that in doing so the U.S. Congress has yielded to the intense political pressures that it faced due to the high unemployment, deepening recession and the zeal to get through the Wall Street Reform Act. There is no doubt that non-accelerated filers will face higher cost of raising funds in U.S. capital markets in the absence of auditor certification of their internal controls over financial reporting.

SECTION III: INTERNAL CONTROL REPORTING UNTIL THE 1970s

Accounting historians agree that although it is difficult to pin-point the origins of internal control, there is strong reason to believe that its components such as internal checking and segregation of duties were present in some form or shape during 1492 when Columbus sailed the ocean blue. As Root (1998, 55-56) notes for our purposes, the need for modern internal control emerged in the late eighteenth century when the need for capital to finance the first industrial revolution arose in the United Kingdom followed later by its spread in Europe and the United States. Studying auditor judgment in evaluating internal accounting control, Mock and Turner (1999, 7) note that since the early part of the twentieth century, auditors have taken into account the adequacy of their client's internal accounting control systems while designing their audit work. They also note that the 1917 edition of Robert H. Montgomery's famous auditing book provides the following specific guidance in this regard "if the auditor has satisfied himself that the system of internal check is adequate, he will not attempt to duplicate work which has been properly performed by someone else" (p. 7).

A glimpse of management's responsibility for maintaining internal control is evident in Brink's (1941) account of origins of internal auditing where he notes "the various revenue acts, social security legislation, minimum wage legislation and particularly the regulations of the Securities and Exchange Commission have defined management's responsibility for the accuracy

of information submitted" (p. 6-7). As is seen later in this paper, such thinking has continued to exist throughout the ensuing decades until finally the Sarbanes-Oxley Act of 2002 codified unequivocally management and auditor's separate roles and responsibilities in maintaining, evaluating and reporting on the effectiveness of internal controls over financial reporting.

Prior to the 1929 stock-market crash in the U.S., since there were no formal or authoritative standards in place, the accounting and auditing practice was essentially guided by precedents. The first nascent attempt to formalize the practice came in 1917 in the form of a Federal Reserve Bulletin prepared by the newly formed American Institute of Accountants under the title of "Approved Methods for the Preparation of Balance Sheet Statements" (Carey 1970, 20). However, it was not until its third revision in 1936 under the title "Examination of Financial Statements by Independent Public Accountants" that a reference was made in this bulletin to "...the propriety of reliance on effective systems of internal control" (p. 21). With regard to the third revision of the bulletin, Mock and Turner (1999) emphasize two specific points. One, the bulletin emphasizes the importance of evaluating internal accounting control in the very first sentence, and two that it defines for the first time the term "internal control." Therefore, one can conclude that this revision established a conceptual foundation for internal control which had therefore been lacking until then.

Since the guidance in the revised bulletin "closely paralleled portions of the correspondence with the [New York] Stock Exchange" its issuance by the Institute helped it gain the cooperation of the Stock Exchange which had jurisdiction over all publicly listed companies but it also averted the SEC take-over of the accounting and auditing standard-setting. The newly enacted Securities Acts of 1933 and 1934 vested the SEC with the "power to prescribe accounting methods to be followed by registrants in statements filed with the Commission" while also leaving to its "discretion to determine whether or not financial statements of registrants should be audited by independent

accountants" (Carey 1970, 5-6). In this regard, the Commission on Auditor's Responsibilities (Cohen Commission 1978) also notes that "as early as 1933, the New York Stock Exchange stated that auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcations of major importance" (p. 61).

McKesson & Robbins' Effect

As the Institute was busy establishing "rational conceptual foundation on which the responsibility of independent auditors could be based" (Carey 1970, 5) the disclosure of fraud committed by McKesson & Robbins' management on December 5, 1938 dealt its efforts a significant blow. Within two weeks of the fraud's disclosure, the SEC ordered an investigation "focusing on the extent to which prevailing auditing standards and procedures were adhered to by the independent auditors of McKesson and the adequacy of the safeguards inhering in such standards and procedures to assure reliability and accuracy of financial statements" (Carey 1970, 25). This had a chilling effect and the public viewed it as if "the entire accounting profession was, in effect, on trial" (Carey 1970, 25). The SEC report charged that Price Waterhouse & Co., auditors of McKesson & Robbins had "failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking, and is recommended in all well-known and authoritative works on auditing" (Carey 1970, 37).

Undoubtedly, the impact of the McKesson Case on accounting and auditing practice was significant as it led the Institute to form a Standing Committee on Auditing Procedures and also prompted the SEC to pay attention to "audit quality" and to set the record straight with respect to the "relative responsibility of management and the independent auditor" (Carey 1970, 147) when it comes to providing reliable financial information to the investors and creditors for decision-

making. Consequently, in 1939 the Committee on Auditing Procedure issued its first Statement on Auditing Procedure (SAP) under the title of "Extensions of Auditing Procedure" which "later became a framework for generally accepted auditing standards" (Mock and Turner 1999, 9). This statement clearly noted that "it is the duty of the independent auditor to review the system of internal check and accounting control so as to determine the extent to which he considers that he is entitled to rely upon it (Mock and Turner 1999, 9-10). Likewise, in its *Report on Investigation of the Securities and Exchange Commission in the Matter of McKesson & Robbins, Inc.* the Commission criticized the audit quality and emphasized the importance of auditor's thorough understanding of a client's "internal check and control" (Root 1998, 66). In a 1939 speech, then SEC's Chief Accountant, William W. Werntz, further clarified this role of the independent auditor when he noted that "to justify reliance, it is implicit that the auditor thoroughly inspect the system..." (Carey 1970, 147).

In a 1939 ruling coming out of the *Interstate Hosiery Mills* case, the SEC made further efforts to clearly answer the question "whose financial statements are these anyways" when it noted that "the fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligation in this respect by the employment of independent public accountants, however reputable...Accountants' certificates are required not as substitutes for a management's accounting of its stewardship, but as a check upon that accounting" (Carey 1970, 63).

The Commission also blessed the Institute's efforts to clarify independent auditor's role with regard to a registrant's internal control system when it issued Regulation S-X in 1940. It also allowed a company's independent auditor to rely on "an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff" (Mock and Turner 1999,

10). The 1941 amendments broadened Regulation S-X by requiring that "in determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control" (Mock and Turner 1999, 10).

Committee on Auditing Procedure

The Institute did not remain passive to these developments in its external environment. In response its Committee on Auditing Procedure in 1949 issued an analytical study titled *Internal Control: Elements of a Coordinated System and Its Importance to Management and the Independent Public Accountant.* In this study the Institute clearly recognized the "complimentary nature" of the respective responsibilities shared both by management and the independent auditors in providing "dependable accounting results" to financial statement users via an effective system of internal control. In doing so, the Committee observed in the first paragraph that "...in most engagements undertaken for the purpose of expressing his independent expert opinion upon the fairness of management's representations, the public accountant expects the company's accounting department to produce financial statements and collateral accounting records which management is satisfied are proper, complete and free of material error" (AIA 1949, 5). Later in the study, when discussing internal control the Committee unequivocally draws the line between the responsibilities of management and the external auditor by stating that "while the primary responsibility for the establishment and enforcement of internal control measures rests with management, the degree to which such measures exist and are carried out is of great concern to the public accountant" (p. 18).

Elaborating further on management's responsibility the Committee noted that "management has the responsibility for devising, installing, and ...supervising a system of internal control adequate to: (1) safeguard the assets of an organization; (2) check the accuracy and reliability of accounting data; (3) promote operational efficiency; and (4) encourage adherence to prescribed

managerial policies..." (p.17). While continuing to emphasize, management's role and responsibility the Committee even goes a step further when it notes that "effective internal control is so pertinent to the question of the reliability of financial data and so fundamental to a proper discharge of management's total responsibility as to require that management be prepared to demonstrate the steps taken to attain it" (p.17). Thus, it was for the first time management's and auditors' respective responsibilities, as they related to a company's internal control system, were clearly articulated by an eminent private-sector accounting body. As a result of this study and the follow-up efforts by the Institute[2] by the end of the 1970s, independent auditor's review of internal control for the purposes of determining nature, timing, and extent of the substantive testing and special-purpose reporting on an entity's internal control system had almost become a settled part of an auditor's responsibilities.

SECTION IV: FOREIGN CORRUPT PRACTICES ACT OF 1977 AS A CATALYST

In hindsight, the roots of the SOX internal control reporting requirements can be traced back to the flurry of legislative activity during the 1970s that culminated in the passage of the Foreign Corrupt Practices Act of 1977. The period of the 1970s was a period of extreme social, economic and political turmoil in the United States. During this period the confidence in the American business was at an all-time low. While prominent companies like Penn Central, Equity Funding, and National Student Marketing Corporation declared bankruptcy and faced insider trading and financial fraud charges, the Office of the Watergate Special Prosecutor and the SEC discovered that a number of U.S. Corporations were hiding, through improper accounting and

[2]For example, in 1958, SAP 20 *Scope of the Independent Auditor's Review of Internal Control* distinguished internal accounting controls from internal administrative controls by recognizing that accounting controls have a direct bearing on the quality of the financial reporting. Likewise, in 1971, SAP 49 *Reports on Internal Control* recognized the fact that auditors, at that time, were furnishing internal control evaluation reports "for use by management, regulatory agencies, other independent auditors, and the general public [and concluded that] if such reports were issued the risk of misunderstanding could be reduced by adopting a form of report that described in detail the objective and limitations of internal accounting control and the auditor's evaluation of it" (Mock and Turner, 1999, pp. 12-13).

record keeping, their use of corporate funds for illegal foreign and domestic political contributions from their shareholders, boards of directors, outside auditors and general counsels.[3]

Recounting Congressional response to the events of the decade, Langevoort (2006, 951) notes that "concern about the adequacy of internal controls—and corporate accountability generally—was one of the most important issues in securities regulation in the 1970s. Because a handful of large corporations had funded the break-in of the Democratic Headquarters, the Watergate scandal led directly to questions about the legitimacy of corporate managers' opaque dominion over corporate assets, especially as it related to foreign and domestic bribery and illegal political campaign contributions. An aggressive SEC enforcement program focusing on 'management integrity' ensued and with more and more misbehavior publicized, Congress responded with the FCPA"[4]. Interestingly enough, like SOX, the FCPA was also passed with a unanimous vote (Root 1998, 71).

Congress passed the FCPA to curb these insidious business practices through criminalizing bribery and illegal payments and forcing their disclosure in the SEC public filings. Among its four sections, of particular interest to this paper is the books and record provision of the Act which amends Section 13 (b) (2) of the Securities and Exchange Act of 1934 by requiring SEC issuers to

> A. Make and keep books, records, and accounts, which, in reasonable detail, accurately, and fairly reflect the transactions and dispositions of the assets of the issuers.
> B. Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
> (i) transactions are executed in accordance with management's general or specific authorization;
> (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted

[3] These practices were so widespread that "under a voluntary disclosure program established by the SEC, more than 200 companies disclosed corrupt practices and questionable foreign payments aggregating more than $2 billion over several years" (Root, 1998, p. 71).
[4] The Act was subsequently amended in 1988 and 1998 to bring it in conformity with the Organization for Economic Cooperation and Development's (OECD) agreement on bribery.

accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences (ABA, 1994).

This genesis of the books and records provision of the FCPA lies in the investigations conducted by the SEC and the recommendations that it made in its *Report on Questionable and Illegal Corporate Payments and Practices*[5] (a.k.a. May 12 Report since it was submitted to the Senate on May 12, 1976) submitted to the Senate Committee on Banking, Housing and Urban Affairs. In this report, the Commission reported on the results of its investigations and informed the Senate Committee that the practice of undisclosed questionable or illegal corporate payments was widespread in American Corporations. The Report also concluded that:

> The almost universal characteristics of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. Millions of dollars of funds have been inaccurately recorded in corporate books to facilitate making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors. Accordingly, the primary thrust of our actions has been to restore the efficacy of the system of corporate accountability and to encourage the boards of directors to exercise their authority to deal with the issue (SEC Release No.13185).

In addition to aggressively enforcing the disclosure regime mandated under the Securities Exchange Act of 1934, the Commission proposed a two-pronged approach to prevent such abuses in the future. First, it recommended that Congress enact legislation that would (1) require issuers to keep accurate books and records, (2) require issuers to devise and maintain a system of internal accounting control designed to achieve objectives as set out in the AICPA's *Statement on Auditing*

[5] Report on Questionable and Illegal Corporate Payments and Practices as submitted by the SEC to the Senate Banking, Housing and Urban Affairs Committee. May 12, 1976.

Standards No. 1, Section 320.28 issued in 1973, (3) prohibit issuers from falsifying accounting books and records, and (4) prohibit issuers from making false, misleading or incomplete statements to their external auditors in connection with the audit. Second, the Commission focused on strengthening the "independence and vitality" of corporate boards of directors by recommending that the NYSE and other relevant self-regulatory organizations require publicly listed companies to maintain independent audit committees and separate the functions of independent corporate counsel and director.

On the very same day, when the SEC submitted its report, Senator Edward Proxmire (D-Wisconsin), Chairman of the Senate Banking, Housing and Urban Affairs Committee, followed-up by introducing the legislative proposals from SEC's "May 12 Report" as S. 3418 in the 94th Congress[6]. In opening the Senate Banking Committee Hearings on May 18, 1976 on S. 3418 and other related bills, Senator Proxmire commented that S. 3418 "would merely codify the requirement that a corporation keep honest books and records, a requirement that is at least implicit in the entire system of corporate accountability" (Mautz, et al. 1980, 411).

Senator Proxmire's S. 3418 was eventually referred by the Committee to the Senate floor as S. 3664. During the Senate debate, two Senators (John Tower (R-Texas) and Forrester Church (D-Idaho)) raised concerns about (1) whether the bill intends to expand SEC's current authority and (2) would implementing the internal accounting control provisions prove to be troublesome in practice. These Senators also questioned how making certain changes to internal accounting controls of a corporation would remedy the bribery issue at hand. In his response, Senator Proximire linked the internal accounting control provisions of the bill to discovering bribery by noting that "it requires that the businessmen of the country must be responsible to set-up an accounting system that will

[6] The discussion in the next few pages is based on material as cited and also on the information and discussion contained in pages 410-420 of the FERF Research Study "Internal Control in U.S. Corporations" by Mautz, et al. 1980.

inform them of what happens to their assets so that, if a bribe is paid, they will know" (Mautz, et al. 1980, 412). On September 15, 1976, the Senate passed S. 3664 unanimously by a vote of 88-0 (SEC Release #34-13185, 1977).

The House Finance Subcommittee hearings on S. 3664, conducted in September 1976[7], presented conflicting views on the internal accounting control provisions of the bill: questionable and illegal payments occurred because the current systems of internal accounting controls were circumvented by management as opposed to the fact that existing systems of internal control maintained by the companies were inadequate or ineffective.

Interestingly, in his testimony to the House, then SEC Chairman Roderick M. Hills (Republican under President Gerald Ford) "testified that the problem was circumvention of existing systems rather than the systems themselves or evaluation of those systems by the auditors" (Mautz, et al. 1980, 412). Consequently, he went on to lend his support to the "accuracy of the books and records" provision by noting that "...it seems to us we should get right to the heart of the matter and charge the corporate officers with keeping accurate and fair records" (Mautz, et al. 1980, 413). Thomas Holton, Chairman of the AICPA's Committee on SEC Regulations sided with the SEC Chair's view and said that from analyzing more than 100 cases involving questionable and illegal payments "...there is no indication that it was the lack of adequate systems of internal accounting controls of these companies that resulted in the abuses and prevented their detection and disclosure. Instead, the abuses usually involved circumvention of internal accounting controls" (Mautz et al., 1980, 413).

Representative John E. Moss (D-California), author of H.R. 13870 that also contained the internal accounting control provision, disagreed. He concluded that indeed internal accounting

[7] "The Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce met on September 21 and 22, 1976 to consider S. 3664 and several House bills with accounting provisions similar to those in S. 3664" Robert Mautz, et al., (1980), FERF, p. 412.

controls were a problem and in some cases auditors were also delinquent in their duties. Citing inappropriate entries, off-the-books slush funds, off-shore bank accounts, shell entities, Representative Moss noted that:

> These accounting gimmicks point to part of the underlying problem, the ineffectiveness of internal corporate accounting and auditing controls. A system of internal controls enables a corporation to insure that its executives and other employees handle its business in a way that protects shareholders' assets. In addition, an effective system of internal controls is essential to perform a valid independent audit (Mautz et al., 1980, 414).

The AICPA and the Federal Regulation of Securities Committee of the American Bar Association noted practical implementation and enforcement challenges facing the proposed "internal control" provision because it was attempting to transform an existing accounting and auditing standard into a legal standard, the violation of which would carry civil and criminal penalties for a company's corporate officers. In hindsight, this debate was laying the foundation for the requirements listed in Section 906 of SOX which criminalizes false certification of a company's financial statements by its senior financial management with penalty and jail-time. The House Finance subcommittee concluded its hearings on September 22, 1976 and the 94th Session of the House adjourned without any final action on the S. 3664.

Senators Proxmire and Williams persisted and (re)introduced S. 305 on January 18, 1977 in the 95th Session of Congress[8]. During the Senate hearings the debate continued. The Auditing Standards Committee of the AICPA sided with those raising the implementation and enforceability concerns noting that

> We do not believe that the existing auditing literature, prepared to guide auditors in determining the scope and nature of examinations of financial statements, provides sufficient guidance to enable registrants to determine the adequacy of a system of internal accounting control as contemplated by the proposed

[8] As introduced, Title I of the Bill was identical to S.3664, the measure which the Senate had passed unanimously during the 94th Congress and title II was substantially the same as Title II of S. 3084.

> rule...Pending development of such criteria, we recommend a delay in the effective date of this section of the proposed rule (Mautz et al., 1980, 417).

The critics contended that SAS 1, the source standard at the base of this requirement, does not provide sufficient guidance to company management in determining the adequacy of their internal accounting controls. Nicholas Wolfson, a former SEC Assistant Director challenged this assertion by noting that

> "...if we were to accept the protestations of some critics of the bill that these standards are too vague, then our free enterprise system would be in critical condition. It would mean that after 40 years of SEC regulation and the careful efforts of distinguished accounting firms, there are still no meaningful accounting standards in the crucial area of internal accounting controls. If so, who would be foolhardy enough to buy stock in or ever again trust the financial statements of corporations?" (Mautz et al., 1980, 416).

Interestingly, the Commission was lobbied and chastised with the same line of arguments and proposals of postponement when it was writing rules to implement Section 404(a) of SOX. Just as soon as the newly created Public Company Accounting Oversight Board (PCAOB) completed its work on the infamous and now withdrawn Auditing Standard #2 (AS 2), the Commission mandated compliance with Section 404 for all but non-accelerated filers with a year-end on or after November 15, 2004. During the first-year of the implementation of public reporting on internal control, both the PCAOB and the SEC were in the line of fire, the PCAOB because of AS 2's apparent "micro-auditing" of internal controls and the SEC for not providing any guidance to registrant companies on how to assess and report on the adequacy of their internal controls over financial reporting. Finally, the SEC capitulated and issued Interpretive Guidance, effective June 27, 2007, for registrants to follow to comply with public reporting on internal control under Section 404(a).

A day after Senator Proxmire introduced S. 305 in the U.S. Senate, the SEC lent its support by issuing Release No. 13185 on January 19, 1977. The release proposed to require issuers to "(1) maintain books and records accurately reflecting the transactions and disposition of assets of the

issuer, and (2) maintain an adequate system of internal accounting controls designed to provide reasonable assurance that specified objectives are satisfied. These proposals would also explicitly (1) prohibit the falsification of an issuer's accounting records; and (2) prohibit the officers, directors, or stockholders of an issuer from making false, misleading or incomplete statements to an accountant engaged in an examination of the issuer."

On April 7, 1977, the Senate Banking Committee report (Siedel 1981)concluded that (1) internal accounting control definition and objectives are taken from AICPA's SAS #1, (2) no system of internal accounting controls is perfect, (3) since cost/benefit relationship are important in meeting the internal accounting control provision the company management must be guided by the standard of reasonableness, and (4) the evaluation by the independent auditors is important in determining the effectiveness of the internal accounting controls, and (5) the accounting provisions in the bill are designed to operate in conjunction with the other criminal penalty provisions of the bill to deter corporate bribery. The Senate on May 5, 1977 unanimously passed S. 305.

The House Finance Subcommittee considered H.R. 1602 and H.R. 3815. The former bill was similar to the passed version of the S. 305 but the later House bill contained no internal control provision. Then SEC Chairman, Harold Williams (Democrat under President Carter) reiterated that the proposed legislation should address the problem of circumventing the internal accounting controls rather than forcing managements' to devise and maintain an effective system of internal accounting controls to provide reasonable assurance. The Committee on Foreign Payments of the New York City Bar Association and the Federal Regulation of Securities Committee of the American Bar Association supported William's view point. In the end, the House passed H.R. 3815, on September 20, 1977, without the internal accounting control requirements.

A conference was needed to reconcile the differences between S. 305 and H.R. 3815. The Conference Committee Report dated December 6, 1977 noted that the House had receded to the Senate's internal accounting control provision. With the conclusion of the floor debate in both chambers of the Congress, the Foreign Corrupt Practices Act was signed into law by President Carter on December 19, 1977.

The Committee on Law and Accounting of the American Bar Association credits the FCPA enormously in elevating the status of internal controls when it states that "by an amazing legislative performance during 1977, internal accounting control was transformed semantically, in the very words of the auditing literature, by an act of Congress from a subordinate aspect of auditing procedure to a formidable requirement imposed on SEC-reporting issuers as substantive federal law" (ABA 1994, 893).

Thus, it was the FCPA that for the first time "openly" held a company's management accountable for maintaining its books and records fairly, accurately and in reasonable detail along with the system of internal accounting control underlying the preparation of such books and records.

Relating the FCPA requirements to SOX internal control provisions Moeller (2007 150) notes that "although, it dates back to an era of minimal automation and many manual processes, it provided a good precursor to today's SOX requirements. Perhaps, if there had been more efforts in achieving FCPA internal control compliance years ago, we would never have had some of the issues that led to today's SOX." Overall, the FCPA "introduced a strong set of governance rules to U.S. corporations; because of the FCPA, many companies' boards of directors and their audit committees began to take an active part in directing reviews of internal controls" (Moeller 2007, 149).

In summary, although the FCPA[9] "made it clear that it is illegal for a public company to have an inadequate system of internal control" (Vanasco et al, 1995, 29) the Act did not at this time require public reporting on the effectiveness of internal control either by management or the external auditor. In vain, the Senate version of the Act entitled "Foreign Corrupt Practices and Domestic and Foreign Investment Improved Disclosures Act of 1977" did state that the independent auditor's comments and suggestions to management on possible improvements in their internal controls are to be encouraged (P.L. 95-213, 1977).

The hearings that led to the passage of the FCPA also raised concerns about the quality of audits. Senator Metcalf from Montana conducted additional hearings and in December 1976 published a highly critical Staff Study entitled *The Accounting Establishment*. In the cover letter dated December 7, 1976 that accompanied this study, Senator Lee Metcalf wrote to the Senator Abraham Ribicoff, Chairman of the Senate Government Operations Committee

> In particular, I am disturbed by two of the study's major findings. The first is the extraordinary manner in which the SEC has insisted upon delegating its public authority and responsibilities on accounting matters to private groups with obvious self-interests in the resolution of such matters. The second is the alarming lack of independence and lack of dedication to public protection shown by the large public accounting firms which perform the key function of independently certifying the financial information reported by major corporations to the public (The Accounting Establishment: A Staff Study, 1976).

Interestingly, the Metcalf Report (a.k.a. The Accounting Establishment: A Staff Study) contained many recommendations that eventually found their way into the Sarbanes-Oxley Act of 2002. For example, Recommendation #6 stated that "the federal government should establish auditing standards used by independent auditors to certify the accuracy of corporate financial statements and records" (similar to the Public Company Accounting Oversight Board (PCAOB) mandate to set

[9] American Bar Association's Committee on Law and Accounting noted that "despite the term Foreign in the title of the Act, the thrust of the accounting and internal controls provisions was, in practice, primarily domestic." See footnote 20 in "Management Reports on Internal Control: A Legal Perspective" published in the Business Lawyer, vol. 49, February 1994, page 894.

auditing standards under SOX); Recommendation #7 stated "the Federal Government should itself periodically inspect the work of the independent auditors for publicly-owned corporations" (similar to the mandated PCAOB inspections under SOX); and Recommendation #8 stated "the Federal Government should restore public confidence in the actual independence of the auditors who certify the accuracy of corporate financial statements under the Federal securities laws by promulgating and enforcing strict standards of conduct for such auditors. Those standards should specifically prohibit activities by auditors which impair their independence in fact or appearance" (similar to SOX provisions prohibiting many non-audit activities).

To follow-on the Metcalf Hearings and the Senate Staff Study, in 1978, additional legislation was introduced in the House as H.R. Bill 13175 by Congressman John E. Moss (D-California). The bill was called the *Public Accounting Regulatory Act* which as drafted was Congressional response to many of the same concerns that lead to the enactment of the Sarbanes-Oxley Act of 2002. These concerns centered around (1) failure of publicly listed companies resulting in losses to investors, (2) whether external auditors were adequately performing their functions of independent review and detection, (3) failure of the accounting profession to establish a satisfactory self-regulatory oversight process, and (4) failure of the accounting profession to develop needed accounting principles and auditing and quality control standards on a timely basis.

To address these concerns, H.R. 13175 proposed creating a new organization named The National Organization of Securities and Exchange Commission Accountancy to (1) register independent public accounting firms which furnish audit reports in connection with any federal securities law, (2) conduct a continuing program of review and investigation of audits performed by independent public accounting firms registered under the Act, and to (3) take appropriate disciplinary action against such accounting firms. The proposed legislation would have also

required this new organization to clarify and define the responsibilities of the Commission with respect to accounting principles and auditing and quality control standards as they relate to publicly owned corporations. Other duties of the organization would be to conduct individual reviews of independent public accounting firms registered under the Act and take appropriate actions against such firms. The new organization would be managed by a board of five directors with no more than two members being from independent accounting firms. These members would be appointed by the SEC.

Unfortunately, upon the death of one of the key congressional backers and another one not standing for reelection, the legislation was not enacted. In hind-sight, it is interesting to note that some of the provisions from this 1978 proposed legislation correspond significantly to the Sarbanes-Oxley Act of 2002. For example, the 1978 legislation suggested creating an oversight body for the accounting profession much like the Public Company Accounting Oversight Board (PCAOB) created by SOX, and it recommended strengthening the audit committees and enhancing enforcement similar to the provisions in SOX (Sections 301, 302, and 906). Noteworthy here is the fact that H.R. 13175 did not propose to strip the private-sector of its auditing standard-setting privileges as done later under the SOX. Thus, in 1978, the groundwork was being laid for federal oversight of the auditing profession that would finally get passed in the Sarbanes-Oxley Act of 2002.[10]

SECTION V: COMMITTEES AND COMMISSIONS OF THE AICPA

The scandals of the 1970s that led registrant managements accountable for keeping accurate books and records along with maintaining an internal control system also highlighted inadequacies in external auditors' testing of internal controls of publicly listed companies in the U.S.

[10] The same legislation was reintroduced in Congress again in 1995 as part of the tort reform law known as the Private Securities Litigation Reform Act and again it failed to pass. Also see Private Securities Litigation Reform Act of 1995, December 22, 1995, Public Law 104-67

Consequently, the American Institute of Certified Public Accountants (AICPA) in 1974 formed a *Commission on Auditors' Responsibilities* (also known as the Cohen Commission) to study independent auditor's responsibilities and recommend measures to close the expectation gap, if any, that existed between what the public expects or needs from the auditor and what the auditor can and should reasonably deliver. The Commission delivered its final report in 1978 (AICPA, 1978).

Relating to internal accounting control, the Cohen Commission (AICPA, 1978) made two specific recommendations. The first recommendation in Section 6 dealt with expanding the scope of the audit function. It required the external auditor to

> ...expand his study and evaluation of the controls over the accounting system to form a conclusion on the functioning of the internal accounting control system. The objective of this study and evaluation would be to enable the auditor to reach a conclusion on whether controls over each significant part of the accounting system provide reasonable, though not absolute, assurance that the system is free of material weaknesses (AICPA 1978, 60).

The second recommendation in Section 7 dealt with communicating to the users of the financial statements that they are management's representations. Specifically, this recommendation urged board of directors or regulatory agencies

> ...to require the company's chief financial officer or other representative of management to present a report with the financial statements that acknowledges the responsibility of management for the representations in the financial information...the report by management should also present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of control systems and a description of the company's response to material weaknesses identified by the independent auditor (AICPA 1978, 77).

As the Commission's work progressed and some clarity emerged on the direction of its potential recommendations, the AICPA, in 1977, concurrently established two separate Special Advisory Committees, one on *Reports by Management* and the other on *Internal Accounting*

Control (a.k.a the Minahan Committee) to provide further guidance both to the company managements and their external auditors on how best to implement Cohen Commission recommendations in these two areas. Both Committees released their reports in 1979.

The *Special Advisory Committee on Reports by Management* started out by reaffirming the long-held division of responsibility between a company's management and its independent auditors with regard to a company's financial statements and disclosures. The financial statements and related disclosures are management's representations and the independent auditor is responsible for opining on the fairness of these statements and disclosures in accordance with the generally accepted auditing standards. On management's report on internal control over financial reporting, the Committee concluded that "internal accounting control plays an important role in ensuring the reliability of the financial statements, and management depends on it to help fulfill its responsibilities for those statements. Thus, management's representation with respect to the company's internal accounting control is an appropriate subject for a report by management" (AICPA 1979a, 4-5). The Committee also noted that the basis of management report on internal accounting control should be "its ongoing evaluation of the design and functioning of the system of internal accounting control" (p. 5). These recommendations are analogous to SOX's Section 302 requirements that mandate management certification of internal controls over financial reporting and SEC's Interpretive Release #33-8810 (2007) that provides guidance to management on how to evaluate the effectiveness of company's internal controls over financial reporting. The Committee also provided in Appendix C, "Sample Management Reports" of a diverse set of companies from their 1978 financial statements.

The AICPA's Special Advisory Committee on Internal Accounting Control, commonly known as the Minahan Committee, focused on providing detailed guidance with a view to helping

managements and boards of directors efficiently comply with the FCPA's books and records requirements. In the process of doing so, it acknowledged the importance of internal accounting controls to the reliability of financial statements and it provided a framework for evaluating and assessing effectiveness of such internal accounting controls and also monitoring compliance to obtain reasonable assurance for the purpose of providing management reports on internal controls (AICPA 1979b, 11-24). The framework put forth by this Committee appears to have formed the basis of the COSO's 1992 Integrated Internal Control Framework that is most commonly referenced by the public companies today in the U.S. to report on the effectiveness of their internal controls over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002.

Following the AICPA's lead, the Financial Executives Institute (FEI) also endorsed Cohen Commission's recommendation on management reporting on internal control by issuing a letter on June 6, 1978 to its membership along with guidelines to assist in public reporting on internal control (ABA 1994, 894 and 1981, 1061-1084). This endorsement by the FEI is important to note because it marked the first-time that the FEI supported management ownership and public reporting of company's internal accounting controls. The FEI also commissioned two research studies (Mautz, et al. 1980, and Mautz and Winjum 1981). While the first study reported on the state of internal control in U.S. companies, the second research study explored the criteria for an adequate system of internal control with a view to assist company managements in assessing and evaluating the adequacy of their internal controls to comply with the FCPA requirements. Following FEI's endorsement, a number of companies started issuing voluntary management reports on their internal controls. The reports varied considerably in content, style and format but it wasn't before too long that the voluntary efforts lost steam and management reports on the effectiveness of internal controls disappeared from the market-place.

SECTION VI: POST-FCPA EFFORTS TO CODIFY INTERNAL CONTROL

The SEC influenced the enactment of the FCPA in 1977 and closely watched the establishment of the two special committees by the AICPA on management evaluation and reporting on internal control. Almost a full-year before the passage of the FCPA, through Securities Exchange Act Release No. 34-13185, on January 19, 1977, the SEC had proposed that management be required to maintain an adequate system of internal control and report to shareholders on its effectiveness. The SEC stated that users of financial information have a legitimate interest in the condition of a company's internal controls as well as to management's response to the auditor's suggestions for corrections of any weaknesses discovered. With regard to the requiring "issuers to devise and maintain a system of internal accounting control" the Release noted that "The establishment and maintenance of a system of internal controls is an important management obligation. A fundamental aspect of management's stewardship responsibility is to provide shareholders with reasonable assurance that the business is adequately controlled" (SEC Release No. 34-13185).

Once the FCPA was enacted, the Commission immediately began its work to draft the proposed rules. Elaborating on these then SEC Chairman Harold Williams in its first ever report to the U.S. Congress dated July 1, 1978 noted that

> Although rules have not yet been proposed, the Commission is likely to require, in reports filed with it, a representation that an issuer's system of internal accounting controls is in compliance with the provisions of the Act. This could be accomplished through a representation from management that the issuer's system of internal accounting controls meets the objective set out in the Act, together with an opinion of the independent public accountant as to management's representation or through an opinion, similar to management's representation described above from the issuer's independent public accountant (SEC, 1978, 42).

In his January 9, 1979 speech at the AICPA's Sixth National Conference on Current SEC Developments, Chairman Williams again acknowledged the Commission's commitment to management's reporting on their system of internal accounting control. Concurrently, he also noted that the "concept of a management opinion on internal controls raises, however, a host of difficult questions" and that just like developing auditing standards, the Commission expects that accountants will also "...take the lead in formulating techniques and procedures for forming a conclusion on management's representations concerning its system of internal accounting controls" (Williams 1979a).

Within 60 days of the passage of the FCPA, the SEC issued Release No. 34-14478 dated February 16, 1978. This Release was intended to be a notification of the enactment of the FCPA. Two additional Releases were issued, a year later, on February 15, 1979 (Release Nos. 34-15570 and 34-1557) in which the Commission adopted the "Falsification of accounting records and deception of auditors" and "Prohibition against deceptive or misleading statements to auditors" respectively as Rules 13(b)(2) and 13(b)(3) as proposed in the January 19, 1977 Release No. 13185. However, the Commission withdrew the "Maintenance of records" and "Maintenance of a system of internal accounting controls" citing that these two requirements have now been adopted by the FCPA.

On April 30, 1979, the SEC issued the 5th Release No. 34-15772 that proposed rules for the first time on including a "Statement of Management on Internal Accounting Control" in a registrant's annual report. Concurrently, in this Release, the Commission also proposed that such statement be examined and reported on by an independent public accountant. In support of the proposed rules, alongside the recently enacted FCPA requirements, the Commission also cited the recommendations made by the Cohen Commission, the FEI guidelines, and the two reports issued

by the AICPA's Special Advisory Committees (as discussed in Section V above). Specifically, the Proposed Rules in the Release required the following:

> (A). ...statement of management's opinion as to whether, as of any date after December 15, 1979 and prior to December 16, 1980 for which an audited balance sheet is required, and for periods ending after December 15, 1980 for which audited statements of income are required, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that:
>
> > (1) Transactions were executed in accordance with management's general or specific authorization;
> >
> > (2) Transactions were recorded as necessary (i) to permit preparation of financial statements in conformity with generally accepted accounting principles (or other applicable criteria), and (ii) to maintain accountability of assets;
> >
> > (3) Access to assets was permitted only in accordance with management's general or specific authorization; and
> >
> > (4) The recorded accountability for assets was compared with the existing assets at reasonable intervals and appropriate action was taken with respect to any differences.
>
> (B.) ...statements of management on internal accounting control as of dates after December 15, 1979 and prior to December 16, 1980, include a description of any "material weaknesses" in internal accounting control which have been communicated by the independent accountants of the registrant or its subsidiaries which have not been corrected, and a statement of the reasons why they have not been corrected.
>
> (C.) ...for periods ending after December 15, 1980, the statement of management on internal accounting control shall be examined and reported on by an independent public accountant.
>
> > (1) ...the examination be sufficient to enable the independent public accountant to express an opinion as to (1) whether the representations of management in response to proposed Item 7(a) are consistent with the results of management's evaluation of the systems of internal accounting control, and (2) whether such management representations are, in addition, reasonable with respect to transactions and assets in amounts which would be material when measured in relation to the registrant's financial statements. The proposed examination by an independent public accountant of the statement of management

> on internal accounting control would, therefore, require expansion of the independent public accountant's present responsibilities with respect to internal accounting control (SEC Release # 34-157782, 1979, 414-430).

Under these proposals, during the initial first year, the management opinion was to extend only to the conditions existing as of the audited balance sheet date and no external auditor certification of the management's statement was needed. Disclosure of material weakness was limited to the ones that were communicated by the independent accountant and subsequently not corrected. Beyond the initial phase, management's opinion was required to cover the entire period of the registrant's statement of income, and the independent accountants were to "reach independent conclusions as to whether the systems of internal accounting control provided reasonable assurances that transactions were recorded as necessary to permit preparation of annual and interim financial statements in conformity with generally accepted accounting principles;..."(SEC Release #34-15772). Thus, recognizing "moral hazard" the 1979 proposals imposed a discipline on management by requiring a registrant's independent accountant to independently ascertain whether management's representations were consistent with the results of their evaluation. In other words, the external auditors would be required to review management's assessment process with the goal of determining whether it was conducted in a manner sufficient to recognize any material weaknesses that would have rendered management's "reasonable assurance" claim ineffective.

Laudatory as these proposals were at that point in time, it is important to note that they did not go as far as the disclosure requirements under SOX 404(a) which require a company management to "directly" report any material weaknesses discovered during assessment of internal controls over financial reporting rather than reporting only those received via their external auditors. Nevertheless, these proposals provide support to the fact that the idea of public reporting

on internal control by management and concurrent auditor certification of the same had surfaced much before the passage of SOX 404.

After the enactment of the Act, it did not take long for Corporate America to realize that its accounting and internal control provisions may end-up intruding into the internal corporate affairs more than originally realized. Thus, resistance to these requirements started to emerge. For example, Kenneth J. Bialkin, chairman of an American Bar Association committee was quoted as saying

> "The argument can be made that almost every aspect of corporate conduct can be related in some way to books and records or related in some way to the adequacies of controls. One wonders whether or not, in this season of attention to corporate governance and the role of the SEC in corporate governance, this is the jurisdictional hook which may be employed for a more direct involvement by the Commission in the internal operations of issuing corporations" (Siedel 1981, 444).

Also, within 90 days of the issuance of these rules, on July 31, 1979 an ad-hoc committee composed of members of five committees of the Section of Business Law of the American Bar Association submitted a comment letter (ABA 1979) strongly opposing the proposed rules on the following grounds:

> Neither the FCPA nor its legislative history provides any support for a requirement for a periodic compliance certificate on internal accounting controls as proposed.
>
> In the absence of express Congressional mandate, the novelty of the rules proposed by the Release raises a fundamental question as to whether they are within the Commission's rulemaking power.
>
> The rules proposed by the Release do not constitute a "necessary or appropriate" exercise of the Commission's rule-making power:
>
> - A compliance certificate is not necessary
> - Creation of an express private right of action is not appropriate
> - Abrogation of the doctrine of materiality is not appropriate.
> - Intrusion into corporate governance is not appropriate.
> - Use of disclosure for enforcement purposes is not appropriate.

- Compliance disclosure regarding the IAC requirement with its imprecision and uncertainties is not appropriate.

In their comment letter, the ABA also noted that "Even within the Commission's rule-making power, the rules proposed by the Release would not serve the interests of shareholders and investors" (ABA 1979, 314).

As the Commission began to enforce the FCPA mandate and floated the proposals for statements by managements on their company's internal accounting controls, significant anxiety gripped the business community over how broadly and deeply the Commission was interpreting Section 13(b) (2) of the Securities Exchange Act of 1934 that codified the FCPA requirements on books and records and internal accounting controls. Management and boards members became highly sensitized because the Act held them "personally" accountable for any illegal payments made in contravention to the Act's requirements and created the potential for "private right of action" due to signing management's statement on internal accounting controls. The business community revolted by interpreting these actions as "criminalization" of the Corporate America and threatened political backlash.

The severity of the backlash to the April 30, 1979 SEC Release and the pressure being put on the Commission is clearly evident from a speech delivered by then SEC Chairman, Harold Williams, on August 14, 1979 to the American Bar Association's Section of Business, Banking and Corporation Law. The 25-page long speech (Williams 1979b) urged the Corporate Lawyers to support SEC's proposed rules "to shape a philosophy of corporate accountability which will permit the business community to retain public trust and support" (p. 2) and beyond the letter of the law. The following excerpts from the speech provide a flavor of the intensity of the opposition to the SEC's resolve under the proposed rules and Commission's efforts to pacify such sentiment:

I want to examine the accounting provisions of the Foreign Corrupt Practices Act because the debate surrounding them highlights several facets of the larger dialogue over corporate accountability. These facets include extensive public scrutiny of corporate conduct widely viewed as unacceptable; a Congressional response to that scrutiny; governmental efforts to give meaning and content to the resulting legislative directive; a constructive response by some corporations and auditors, coupled with narrow interpretation and protest against further governmental intrusion and over-regulation by many others; and a small but vocal public faction which regards the legislation as inadequate and urges more stringent laws. In the face of these conflicting factors, giving meaningful content to the accounting provisions will not be easy and may prove impossible. (p. 4)

The corporate bar is central to this interaction. To the extent that the profession takes the attitude that the new law should be viewed narrowly and treated as another governmental over-reaction, to be complied with grudgingly, in letter but not spirit, then the Act will accomplish little except to spawn litigation and harden the lines between those who urge more pervasive federal control over corporations and those who advocate less. (p. 4)

Questions are frequently raised concerning the resulting costs...and I do not read the accounting provisions as a mandate to abdicate that judgment in favor of the unthinking application of costly new controls...However, the idea that business ventures funded by the investing public should expend whatever is reasonably necessary, in exercise of good judgment, to install such mechanisms—as a matter of effective management, let alone legal requirement—hardly seems radical. (pp. 11-12)

I do not mean to suggest that concern about the impact of new Section 13(b)(2) is irrational or unfair. I can certainly understand the apprehension of some over the dangers of unthinking application of the accounting provisions. The statute lacks any of the traditional limitations familiar in the federal securities laws, such as materiality concept or the scienter standard applicable in certain private actions. Under these circumstances, it is not surprising that some have predicted that compliance with the Act will be terribly costly; that government or private litigants will refuse to perceive that no internal accounting control system can be fail-safe or foolproof; and that courts may not fully respect the tradeoffs between costs and benefits which are appropriate in structuring an internal control system...Implementation needs to be shaped with sensitivity and sensibility. (pp. 15-16)

Nonetheless, this rulemaking initiative has generated intense opposition...I can, however, say that in proposing [these rules], it was not the Commission's objective to open the door to a program of compliance reporting applicable to the full range of federal law; to lay the ground work for an enforcement effort aimed at ferreting out trivial arithmetic or other bookkeeping inaccuracies; to

> entrap issuers which promptly detect and rectify errors in their records; or to accomplish the other horribles which some of the comment letters envision. (p. 19)
>
> It is however difficult to understand how our management statement rule, if adopted, would require responsible corporations to do much beyond what they would do, absent the rule, in order to comply with the Act. Moreover, although there may be persuasive objections to our proposals, I find it disappointing that much of the opposition seems to have lost sight of the fact that controlling business is a basic, familiar managerial goal. I would urge that, whether or not our reporting proposal becomes a reality, compliance with the Act be approached with that principle in mind. (pp. 19-20)

These voices got only stronger when during the 1980 presidential election campaign, then candidate Regan in his speeches proclaimed that government is not part of the solution rather it is part of the problem. With the election of President Ronald Regan (R) in 1980 and a Republican Senate it became clear that the SEC would now also face political pressure to "tone-down" its resolve to implement and enforce the books and records and the adequacy of internal control provisions as intended under the April 30, 1979 Release.

Not too long after President Regan stepped in the oval office, the SEC still under the Chairmanship of Harold Williams (D) issued on June 6, 1980 SEC Release No. 34-16877 announcing the withdrawal of the Release No. 15772 dated April 30, 1979 that proposed a Statement of Management on Internal Control. While withdrawing these proposals the Commission danced around and justified the withdrawal while continuing to make the case for public reporting on internal control. The following excerpts from the summary of the withdrawing Release are indicative of the difficult position the Commission found itself at that time:

> The Commission's decision to withdraw the rule proposals at this time is based, in part, on a determination that the private-sector initiatives for public reporting on internal accounting control have been significant and should be allowed to continue. The Commission believes that the action announced today will encourage further voluntary initiatives and permit public companies a maximum of flexibility in experimenting with various approaches to public reporting on

> internal accounting control. Further, the Commission urges similar experimentation concerning auditor association with such statements.
>
> The withdrawal of these proposals at this time should not be interpreted as change in the Commission's views concerning the importance of effective systems of internal accounting control and of management reporting on and auditor examination of such controls.
>
> The Commission's rule proposals concerning internal control reporting met substantial opposition. Many commentators viewed the proposals as having the effect of requiring a report on compliance with law, rather than as providing a medium for meaningful disclosure to investors. Objections were also raised concerning the costs of compliance with the proposed rules and the scope and content of the proposed management statement.
>
> Thus, although the Commission is withdrawing its rulemaking proposals at this time, it continues to believe that a report containing management's assessment of the effectiveness of the issuer's system of internal accounting control would provide information important to investors, and that auditor involvement with such a report may be needed.

Additionally, in a 1981 formal statement the SEC pledged to read the law narrowly, the position from which the SEC did not deviate in the ensuing years. From then on the "accounting control provisions were essentially only raised in enforcement actions when there was evidence of actual misreporting by the issuer, so that any controls failure claim was largely surplusage" (Langevoort 2006, 953). In a nutshell, the whole "fanfare" on public reporting of internal control by management ended-up with further protections for the external auditors emanating from making management of a company responsible for its financial disclosures but neither requiring the management nor the external auditors to publicly report on the adequacy of its internal controls over financial reporting.

It was not until 1988 that the SEC resurrected its internal control reporting proposals by issuing Release No. 34-25925 under the title of "Report of Management Responsibilities." Like the 70s, this time around the primary drivers were the Congressional scrutiny of the accounting profession in light of the financial frauds committed by companies like Drysdale Government

Securities, Washington Public Power Supply System, Baldwin-United Corporation, ESM Securities and the ZZZZ Best Corporation in the mid-1980s (Grundfest and Berueffy 1989). The House Committee on Energy and Commerce under Representative John Dingell's (D-Michigan) chairmanship had convened hearings into the causes of these frauds and whether they could have been prevented in any way by the external auditors.

Foreseeing the congressional scrutiny and the impending regulatory proposals from the SEC, the accounting profession also voluntarily initiated self-examination into the deteriorating quality of financial reporting by the public companies and the means to enhance audit quality. The following initiatives ensued: (1) establishment of the Treadway Commission by the Committee of the Sponsoring Organizations[11] to study the causes and to make recommendations to reduce the incidence of the fraudulent corporate financial reporting; (2) issuance of a position paper titled 'Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence" by one of the Big-4 public accounting firms, Price Waterhouse; and (3) publication of a position paper titled "The Future Relevance, Reliability, and Credibility of Financial Information" by the heads of the seven major public accounting firms.

More than 25 Congressional hearings resulted in Representative Ron Wyden (D-Oregon) introducing two versions of the legislation as H.R. 4886 and H.R. 5439[12] both under the title of "Financial Fraud Detection and Disclosure Act of 1986."[13] Several Representatives including House member Dingell (D-Michigan) joined with him on these bills as their co-sponsor. The

[11] The five private sector organizations that formed the Committee of the Sponsoring Organizations of the Treadway Commission are: American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, Institute of Management Accountants, and the Institute of Internal Auditors.

[12] It should be noted that Representative Wyden had consecutively introduced two bills in the House, one on May 22, 1986 as H.R. 4886 and the other on August 15, 1986 as H.R. 5439. Also important to note is that Senator Heinz (D-Pennsylvania) has introduced S. 430 in the Senate that proposed to consolidate FCPA's books and records, and the internal control requirement into one by making accurate record-keeping requirement as one statutory objective of the internal control scheme." See p. 509 of the "Foreign Corrupt Practices Act" 24 American Criminal Law Review, vol. 24, 1986-87, pp. 587-601.

[13] H.R. 4886 was introduced on May 22, 1986 and H.R. 5439 was introduced on August 15, 1986.

Wyden bills proposed to significantly expand independent auditor's responsibilities. In a statement before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, John Chad (R), then SEC Chairman under President Regan, summarized internal control aspects of H.R. 4886 as follows:

> H.R. 4886 would require those conducting "financial examination' to evaluate both the accounting and administrative controls of a registrant to determine whether these controls "reasonably ensure" that "(A) receipts and expenditures comply with applicable law; (B) funds and other assets are properly safeguarded against waste, loss, unauthorized use, and misappropriation; and (c) receipts and expenditures are recorded and accounted for properly." It would also require those conducting such examinations to issue a written report that "contains a statement of the auditor's or examiner's evaluation of the internal accounting and administrative controls...and an identification of any weakness in such controls." Further, the bill cautions that "nothing in [the bill] shall be construed to relieve any auditor or examiner from the responsibility to detect and disclose...any defect in any internal accounting and administrative control because such...defect is not material to the ...document that is being prepared or certified..." (Shad 1986, 12-13).

These congressional efforts were met with resistance both from the private sector and the SEC. Sullivan (1993, 234-235) notes that "there was again strong opposition to the internal control reporting requirements, particularly by the FEI." While describing the Commission's views on the internal control aspects of the H.R. 4886, John Chad noted that:

> Internal control systems are an important measure in assuring corporate accountability. Adequate controls and strict adherence to those controls, in many circumstances will serve to deter fraud and aid in the detection of fraud. The Commission's concerns with the internal control provisions of H.R. 4886, therefore, center on definition of certain terms (e.g., the scope of the terms such as "financial examination") and the cost-benefit aspects of the bill. In reviewing a similar 1979 proposal, the Commission found that the costs of requiring a management report on internal controls exceeded the benefits, and this bill would compound the requirements by including an examination and report by the auditors of controls, including administrative controls. Therefore the Commission does not support the internal control provisions of H.R. 4886 (Shad 1986,14).

The H.R. 4886 failed to muster enough support within Congress, the SEC and the private sector to pass into law. Once again, public reporting on internal control remained an unfulfilled goal of the

investor-protection advocates who believed that management reports on internal controls anchored with concurrent auditor review and certification are important pieces of the puzzle to enhance financial reporting and audit quality.

In October 1987, the National Commission on Fraudulent Financial Reporting (also commonly referred as the Treadway Commission) issued its final report. It included many recommendations concerning the internal controls of public companies. In one of the key recommendations, the Treadway Commission recommended that

> All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and the chief accounting officer and/or the chief financial officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of a company's internal controls. (p. 41).

To defend its recommendation, the Treadway Commission (pp. 44-45) noted that "the investing public has a legitimate interest in the extent of management's responsibilities for the company's financial statements and internal control and the means by which management discharges its responsibilities. Yet these responsibilities are not always communicated to the investing public." It is important to note that the Treadway Commission did not recommend public reporting on internal control by an issuer's independent accountants. However, it did recommend that auditor's report "should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control" (p. 13).

David S. Ruder (R), then Chairman of the SEC under President Regan, provided a testimony to the House Oversight and Investigations Subcommittee, chaired by Representative Dingell (D-Michigan) concerning Treadway recommendations. In his testimony, Ruder supported the Treadway's recommendation on management reporting while arguing from the Commission's

perspective why a management report would be a beneficial disclosure to the investors (Ruder 1988).

Subsequently, the SEC agreed with its staff recommendations and issued on July 26, 1988 Proposing Release Nos. 34-25925 and No. 33-6789 for comment. In summary, the proposed rules required that:

> Registrants include a report of management's responsibilities (management report) in Forms 10-K and N-SAR and annual reports to security holders. The management report would contain a description or statement of management's responsibilities for the preparation of the registrant's financial statements and other financial information, and for establishing and maintaining a system of internal control directly related to financial reporting. Such report would also include management's assessment of the effectiveness of the registrant's system of internal control and a statement as to how management has responded to any significant recommendations concerning such controls made by its internal auditors and independent accountants. The registrant's independent accountant, pursuant to its existing responsibilities under generally accepted auditing standards, would be required to read the disclosures included in the proposed management report and consider whether such information includes a material misstatement of fact. If the independent accountant concludes that such is the case, he is required to take certain actions that would result in appropriate disclosure (p. 681).

Although, when discussing its management report proposals, the 1988 SEC rule proposals drew substantively from the previously withdrawn 1979 Release (34-15772 dated April 30, 1979), the SEC was very careful in pointing out how substantively the 1988 rule proposals on public reporting on internal control differed from its much despised 1979 rule proposals. Specifically, the SEC noted that (1) while the 1979 release was viewed by many essentially as a statement of compliance as well as establishing the existence of FCPA violations for enforcement purposes, the 1988 rule proposals decouple the management reporting on internal control by establishing a materiality threshold not contained in the FCPA; (2) the 1988 rule proposals focus on the entire system of internal control rather than just the internal accounting controls as mandated by the FCPA, (3) while the 1979 release required management opinion on controls to extend to conditions

that existed throughout the period, the 1988 proposals require for an assessment of effectiveness only at a "point-in-time", and (4) unlike the 1979 Release, the 1988 rule proposals do not require "that the management statement on internal accounting control be examined and reported by an independent accountant." To justify external auditor's non-involvement in management statement on internal control, the Commission invoked then recently issued SAS #55 and #60 because these auditing standards provided for

> ...new responsibilities for independent accountants in their consideration of the internal control structure during an audit and in their obligation to report to the registrant significant matters concerning that structure. These SAS's do not require the auditor to test the effectiveness of, or otherwise examine or audit the control structure. Thus, the auditor would not be in a position to opine on the overall effectiveness of the system (SEC Release #34-25925, p. 684).

However, consistent with the GAO's recommendations, the Release invited comments on whether the independent accountants should be required to report directly on either the registrant's internal controls or the proposed management report especially in the event when auditor's examination reveals a noted misstatement in the management report.

Unfortunately, the 1988 rule proposals also met with resistance. While a majority of the commenters supported the proposed report of management's responsibilities for the preparation of registrant's financial statements and for establishing and maintaining an internal control system, there wasn't majority support for requiring the management to provide an assessment of the effectiveness of its internal control system. Not only was there strong opposition to the idea of management publicly reporting on its company's internal control effectiveness, there was a call for delay in final action on the 1988 SEC's proposals until the private-sector had established a set of standards to conduct such internal control effectiveness assessments. Similarly, the commenters opposed any direct reporting on management's assessment of its internal control effectiveness. The message was loud and clear to the SEC staff. Consequently, after the appointment of a new SEC

Chairman (Richard Breeden (R) under President Bush) the SEC staff withdrew its 1988 rule proposals on April 24, 1992 from its Regulatory Flexibility Act Agenda (SEC Release #6935).

H.R. 4886 languished in the House of Representatives until H.R. 5269 was introduced under the title of "Comprehensive Crime Control Act of 1990." Subsequently, the House passed an amendment to H.R. 5269, submitted by Congressmen John Dingell (D- Michigan), Edward Markey (D-Mass), and Ron Wyden (D-Oregon), which would have amended the Securities Exchange Act of 1934 by requiring each issuer to evaluate its system of internal controls. More specifically, under this amendment, each issuer would have been required to periodically report to its security-holders (1) a description and statement of management's responsibilities for preparation of company's financial statements and other financial information and for establishing and maintaining an adequate internal control structure; (2) an assessment of whether such internal control structure, at fiscal year-end, reasonably assures the preparation of publically filed annual and quarterly financial statements in accordance with GAAP; and (3) the disclosure of any material weakness identified and unpremeditated by a company's management in such internal control structure as of the date of filing of the annual report. Additionally, this amendment would have imposed an obligation on issuers' independent public accountants also by requiring them to (1) examine and report on management's assessment of the adequacy of an issuer's internal control structure, and (2) include this report in issuer's annual financial statements. Although, the amendment imposed other obligations on issuer's independent public accountants relating to related party transactions, illegal acts, and going concern doubts, the above provisions pertaining to public reporting of internal control, both by an issuer's management and its independent public accountants, significantly resemble the internal control requirements promulgated in Section 404 of SOX.

The amendment was supported by the AICPA (Neebes 1990), but it was opposed by the American Bankers Association (Spiegel 1990), and the Financial Executives Institute (FEI 1990). The SEC did not take a position on the Dingell, Markey, and Wyden amendment. However, while testifying before Congress then SEC General Counsel, James Doty, now the Chairman of the PCAOB, pointed to the outstanding 1988 SEC release (33-06789 and 34-25925 dated July 26, 1988) and also raised a concern on auditor's "examine and report" provision based on cost-benefit grounds and the differences such a requirement would create between the disclosure regimes of the U.S. and other nations (Doty 1990).

Since the House amendment was rejected by the Senate conferees and the Senate version of the Crime Control Bill did not include any such comparable requirements, the Dingell, Markey, and Wyden provisions as stated above were not part of the Crime Control Act which was enacted into public law on November 29, 1990. Although, the Senate conferees did not explicitly reject the ideas behind the House amendment but bowed to the pressures from the interest groups by hiding behind the argument that the Senate needed to investigate these issues as there was no record in the Senate that would demonstrate the need for legislation. It was irrelevant to the U.S. Senate that over the years the U.S. House of Representatives had held three dozen or so hearings and that the House had passed the Dingell, Markey, and Wyden amendment to require public reporting of internal control both by an issuer's management and the independent auditors.

Determined to pursue their amendment, Congressmen Markey and Wyden introduced a new bill in the House. It would have required the SEC to study (1) the extent to which the registrants were complying with the "books and records and internal control" provisions of the FCPA and (2) the extent to which corporate financial reporting in America could be improved by requiring companies and their auditors to publicly report on the effectiveness of their internal controls over

financial reporting. Unfortunately, once again, their Bill expired with the end of the 102nd Congress.

Furthermore, the Savings & Loan (S&L) crisis led to the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Among other provisions, the FDICIA required each insured depository institution (i.e., banks) with at least $150 million in assets[14] to provide, in its annual public filings, a management report on the effectiveness of the depository institutions' internal control structure and procedures for financial reporting and an attestation report by its external auditors on the management's report.

Specifically, Sections 36 (b) and (c) of FDICIA that required public reporting on internal control both by bank management and its independent accountants read as follows:

> (b) Management responsibility for Financial Statements and Internal Controls- Each depository institution shall prepare—
>
> > (2) a report signed by the chief executive officer and the chief accounting or financial officer of the institution which contains—
> >
> > > (A) a statement of the management's responsibilities for—
> > > (i) preparing financial statements;
> > >
> > > (ii) establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
> > >
> > > (iii) complying with the laws and regulations relating to safety and soundness which are designated by the Corporation or the appropriate Federal banking agency; and
> > >
> > > (B) an assessment, as of the end of the institution's most recent fiscal year, of—
> > >
> > > (i) the effectiveness of such internal control structure and procedures; and

[14] In 1993, the Federal Deposit Insurance Corporation (FDIC) adopted rules to implement the law for depository institutions with total assets of more than $500 million. In November 2005, the FDIC raised the total asset threshold to more than $1 billion.

> (ii) the institution's compliance with the laws and regulations relating to safety and soundness which are designated by the [Federal Deposit Insurance] Corporation and the appropriate Federal banking agency

(c) Internal Control Evaluation and Reporting Requirements for Independent Public Accountants—

> (1) In General-With respect to any internal control report required by subsection (b)(2) of any institution, the institution's independent public accountant shall attest to, and report separately on, the assertions of the institution's management contained in such report.
>
> (2) Attestation Requirements-Any attestation pursuant to paragraph (10 shall be made in accordance with generally accepted standards for attestation engagements.

Thus, for the first time in 1991, more than ten years before the passage of the Sarbanes-Oxley Act of 2002, an act of Congress, although applied only to the banking sector, succeeded in mandating public reporting on the adequacy of the internal control structure both by the management and the independent accountants. Although, it was hailed as a step in the right direction by investor-protection advocates, FDICIA provisions lacked the following requirements which later were promulgated as part of the SOX: (1) the requirement to specifically identify the framework used by management in evaluating the effectiveness of bank's internal control structure over financial reporting; (2) the requirement that management disclose all material weaknesses in annual filings to the SEC; (3) the requirement that the management is not permitted to conclude that its internal control structure over financial reporting is effective in the presence of any material weakness; and (4) the requirement that independent auditors are required to examine and independently report on the effectiveness of internal control structure over financial reporting. Similarly, FDICIA contained the requirement of "complying with the laws and regulations relating to the safety and soundness" that was not made part of the SOX mandates.

Interestingly enough, the FDICIA legislation came through the same Senate Banking Committee that originated the Sarbanes-Oxley Act of 2002. More likely than not, the FDICIA provisions and implementation experiences served as a model for SOX public reporting on internal control requirements during the congressional debate on Section 404.

Between August 1, 1991 and September 22, 1992, Representatives Wyden, Markey and Dingell reintroduced, on two different occasions, legislation in the House in the area of financial fraud detection and disclosure but ironically none of the two bills[15] contained management and auditor reporting on internal accounting controls. This may have been the result of growing opposition to the public reporting on internal control by both management and auditors due to litigation, cost-benefit, etc. concerns.

Just as the congressional efforts were getting nowhere, the Committee of the Sponsoring Organizations of the Treadway Commission (COSO, 1992) released the first ever Internal Control Framework in September 1992. According to COSO, the Framework establishes a common definition of internal control that "services the needs of different parties for assessing and improving their control systems...provides principles-based guidance for designing and implementing effective internal controls." It is important to note that the COSO Report was silent on the issue of public reporting on internal control by management as well as any involvement by company's independent accountants in certifying management's assessment or directly the effectiveness of the issuer's internal control system.

However, within a month of its issuance, the Framework (a.k.a. the COSO Report) came under heavy criticism, this time by the U.S. General Accounting Office (now known as the General Accountability Office). In the October 30, 1992 letter, then GAO's assistant comptroller general,

[15] H.R. 3159 introduced in the House by Wyden and Markey on August 1, 1991 and H.R. 4313 introduced in the House by Wyden, Markey and Dingell on February 25, 1992 with amendments on September 22, 1992.

Donald H. Chapin bitterly chastised the Internal Control Framework issued by the COSO. Arguing for his assessment of the COSO report, he wrote:

> We are disappointed that the final report is not responsive to our major concerns...we believe that the final report does not underscore the importance of internal controls, falls short of meeting the expectations of the Treadway Commission for management's reporting on the effectiveness of internal controls and misses opportunities to enhance internal controls oversight and evaluation. In general, the report's message does not advance the status of corporate governance and may actually encourage management to lessen its attention to internal controls (Kelly 1993, 10-18).

Whether the COSO 1992 Framework succeeded in changing the ways companies thought of internal controls continues to be a hotly debated issue even today. According to a survey (Krane and Sever 1996) conducted by the accounting firm of Coopers & Lybrand (now PricewaterhouseCoopers) four years after the issuance of the COSO Report, only 7% of the CEOs, 19% of the CFOs and 4% of the mid-level managers acknowledged that they were aware of the existence of the COSO's Internal Control Framework let alone that they were implementing it in their companies to enhance internal controls. This sorry state-of-affairs for COSO Framework continued to exist until SEC rules implementing Section 404 of the SOX tacitly legitimized the 1992 COSO Internal Control Framework as an acceptable Control Framework to assess the effectiveness of internal controls over financial reporting under SOX 404. For example, in a 2006 survey of company managers, commissioned by the Institute of Management Accountants[16], only 14% reported that "their management team utilized COSO 1992, to a large extent, to effectively manage their organization's enterprise-wide risk and controls prior to SOX...and a small number of external auditors (7.2%) were using COSO 1992 Framework, to a large extent, to size-up their

[16] The findings of this research study suggest that reforms relating to public reporting on internal controls should not stop with enactment of SOX "certification and disclosure" requirements but should continue with additional reforms aimed at enhancing the effectiveness of the benchmarks (i.e., 1992 COSO Internal Control Framework) utilized both by the issuers and their auditors in opining on the effectiveness of their internal controls.

company's system of internal control and to report to their company's management their assessment or findings via the annual management letter" (Gupta 2006, 60-61).

On March 5, 1993, the Public Oversight Board (POB) of the SEC Practice Section of the AICPA issued a Special Report entitled "In the Public Interest" in response to the increasing demands by the then Big-8 public accounting firms asking for relief from the litigation burden. While discussing the relevance of reporting on internal control, the POB issued the following recommendation:

> The SEC should require registrants to include in a document containing the annual financial statements: (a) a report by management on the effectiveness of the entity's internal control system relating to financial reporting; and (b) a report by the registrant's independent accountant on the entity's internal control system relating to financial reporting. (p. 54).

In a May 27, 1993 speech, then SEC Chief Accountant, Walter P. Schuetze commended the Public Oversight Board for its hard work and insightful recommendations aimed at improving the quality of financial reporting by the public companies. However, at the same time, he did not lend any support to the "public reporting on internal control by the independent auditors" recommendation citing the plethora of comment letters received by the Commission opposing this requirement in response to its July 26, 1988 Release and doubts about whether auditor involvement in assessing internal controls would prevent "cooked books" (Schuetze 1993).

Countering Schuetze's apprehension and concerns, John Sullivan, Chairman of the AICPA's Auditing Standards Board argued that "if internal controls were subject to audits, some frauds would not have been penetrated" (Sullivan 1993, 20). Following-up on the Public Oversight Board's report, the AICPA issued a proposal entitled "Meeting the Financial Reporting

Needs of the Future: A Public Commitment from the Public Accounting Profession" in June 1993. This proposal supported POB's above-mentioned recommendation when it noted that

> To provide further assurance to the investing public, we join in with the POB in calling for a statement by management, to be included in the annual report, on the effectiveness of the company's internal controls over financial reporting, accompanied by an auditor's report on management's assertions. An assessment by the independent auditor will provide greater assurance to investors as to management's statement. The internal control system is the main line of defense against fraudulent financial reporting. The investing public deserves an independent assessment of that line of defense, and management should benefit from the auditor's perspective and insights. We urge the SEC to establish this requirement. (p. 18).

These private-sector initiatives to involve auditors in public reporting on internal control met with resistance from the SEC as is evident from a speech delivered by Richard Y. Roberts, one of the SEC Commissioners (under Richard Breeden (R), Chairman under President George Bush, Sr.):

> Concerning the internal reporting requirements called for both by the AICPA and the Public Oversight Board, I am inclined to agree with the negative statements made by Commission's distinguished Chief Accountant, Walter Schuetze, on this subject in July...I believe Walter is right, and I am inclined to be of the view that the AICPA's proposal for auditor reporting on internal controls does not pass muster under the proverbial cost-benefit test (Roberts 1993).

It was not until 1996 that the issue of public reporting on internal control resurfaced. This time Congressman John D. Dingell (D-Michigan) who was now a ranking minority member requested the U.S. General Accounting Office (GAO) to provide him with a report on the "status of recommendations made to the accounting profession over the past two decades by major study groups." In response, on September 24, 1996 the GAO issued a two-volume report (GAO, 1996) that inventoried the recommendations made by major study groups during 1972 and 1995 and related actions taken by appropriate entities. The report also listed unresolved issues and their impact on audit quality, accounting and auditing standard setting and scope of business reporting and audit services. With regard to public reporting on internal control both by the management and

the auditors, the report was critical of the SEC for its failure to adopt the requirement that companies report on their internal controls, as well as having the auditors test and report on them. In this regard, the GAO Report (1996) noted that

> The GAO believes that SEC leadership is necessary to achieve reporting on the effectiveness of internal controls by management and independent auditors. Such reporting would greatly enhance the auditor's ability to prevent and detect material fraud...GAO believes that the auditor would be more effective in [detecting fraud] if the effectiveness of internal controls were also assessed. GAO also believes that the auditor/client relationship places the accounting profession in a difficult position in achieving reporting on internal controls and that the SEC is in a key position to provide leadership and support to achieve the changes needed to resolve these major issues (p. 19).

Given that Representative Dingell was a ranking minority member, in the republican-controlled Congress, he did not take any action to follow-through on the report.

VII: CALL TO ACTION AND THE SARBANES-OXLEY ACT OF 2002

In early November of 2001, Enron Corporation which was already under formal investigation by the SEC, conceded that it had "cooked" its books to overstate the 1997 profits by about $600 million. Its independent accountants, Arthur Andersen & Co., issued notices that the company's financial statements prior to June 30, 2001 should not be relied upon. On December 2, 2001, amid accusations of financial fraud, the company filed for bankruptcy protection in the Southern District of New York's Bankruptcy Court.

Once again, fraudulent financial reporting had struck. The corporate conduct and the accounting profession were in the crossfire and under serious investigation both by the House and the Senate. Within 10 days of Enron's bankruptcy filing, the U.S. House of Representatives' Financial Services Committee under Chairman Michael Oxley (R-Ohio) held joint hearings with the subcommittee on capital markets, insurance and government sponsored enterprises and the subcommittee on oversight and investigations. At this first hearing, four witnesses testified

including Joseph Berardino, CEO of Arthur Andersen and Robert Herdman, Chief Accountant of the SEC. What is interesting to read in the transcript of this hearing is the acknowledgment by the SEC's chief accountant that "financial reporting in this country is challenged and appropriate steps need to be taken to learn what needs to be done to improve it, and that should be done quickly."[17] The House held additional seven days of hearings, heard testimonies from 37 different witnesses and produced more than 1800 pages of hearing transcripts. The last hearing, held on July 8, 2002, was titled "Wrong Numbers: The Accounting Problems at WorldCom" because by now the whistle was blown on the proprietary of the accounting statements of another major U.S. corporation.

During February 2002, two bills were introduced in the House, respectively, by Representative Michael Oxley (R-Ohio) as H.R. 3763 and Representative John LaFalce (D-New York) as H.R. 3818. Both bills proposed many of the provisions seen in the SOX but none of the bills contained anything relating to public reporting on internal controls either by the management or the public accountants. One of the co-authors of this paper had testified in the March 13, 2002 hearings arguing for public reporting on internal control both by the management and the external auditors.[18]

Concurrently, Senator Paul S. Sarbanes (D-Maryland), Chairman of the Senate Banking, Housing and Urban Affairs Committee, convened 10 hearings between February 12 and March 21, 2002 on the topic of "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies." The Committee heard testimony from forty prominent witnesses including five former and one sitting chairmen of the SEC, three former SEC chief accountants, one former chairman of

[17] Joint Hearings before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, and the Subcommittee on Oversight and Investigations of the Committee on Financial Services, "The Enron Collapse: Impact on Investors and Financial Markets." U.S. House of Representatives, 107th Congress, First Session, December 12, 2001, Serial No. 107-51, Part 1, page 40.

[18] Hearings before the Committee on Financial Services, "H.R. 3763—The Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002" U.S. House of Representatives, 107th Congress, Second Session, March 13, 2002, Serial No. 107-60, page 52.

the U.S. Federal Reserve, two sitting chairmen of the major accounting standard-setting bodies, one sitting and one former Comptroller General of the United States, and a number of academics, investor advocates, corporate governance experts, lawyers, and corporate leaders. This distinguished group of witnesses shared their views and opinions on what's wrong with the current system of financial reporting and auditing and what can be done to fix it in the wake of Enron and WorldCom scandals. For example, Charles Bowsher, the former Comptroller General of the GAO in his testimony urged the Senate to adopt the SOX 404 requirement. Then sitting Comptroller General of the GAO, David M. Walker, was also supportive of this requirement.

The Banking Committee Staff started circulating a draft of SOX legislation about mid-April 2002. By early May 2002, it had been widely circulated as a committee print of the bill. Business, investors, the accounting profession and others were all provided an opportunity to comment on the committee print of the proposed bill. As a result of that process, a number of changes were made to the proposed legislation.

One of the changes made was to the draft language of what became SOX 404. Originally, it had been "mirrored" after the language in the banking FDICI Act of 1991. However, the FEI again disliked SOX 404 and pushed back and withheld their support for the legislation. As a result of their effort, the language in the committee print was modified to state the audit of the financial statements and audit of internal controls would be a single, not two audits, in essence an "integrated audit approach" would be used to contain the costs. After that change was made, the FEI provided Senator Sarbanes with a letter supportive of the legislation that was made a matter of public record. Thus, no one should question as to whether this section of the Act was given considerable deliberation.

On June 25, 2002, Senator Sarbanes introduced S. 2673 in the Senate. On July 15, 2002, the Senate adopted S. 2673, a good part of which mirrors the earlier 1978 proposed legislation. H.R. 3763 incorporated S. 2673. In certain places, the wording of the combined bill is almost identical to the 1978 legislation. After WorldCom came to light, both the Senate and House overwhelmingly adopted this legislation with many similarities to the bill that had a beginning in 1978, almost a quarter of a century earlier. Not exactly what one might call a "rush to judgment" or "knee-jerk reaction"! The bill became the public law 107-204 on July 30, 2002 when President Bush signed it. It came to be known as the Sarbanes Oxley Act of 2002.

VIII: THE DEBATE AND THE OPPOSITION CONTINUES

Since the enactment of SOX, there continues to be ongoing debate relating to the implementation challenges (Chan et al. 2006) and the costs and benefits of Section 404. Proponents argued that major benefit of effective internal control over financial reporting is that it provides discipline for effective financial stewardship. Also public reporting on its effectiveness holds management, who are the "owners" of the internal control structure, accountable to the investors. Specific benefits identified include a greater awareness of good internal controls, the elimination of redundant controls, and the identification and remediation of control deficiencies. More statistical evidence continues to quantify the benefits. A study focusing on control deficiencies and cost of capital (Ashbaugh-Skaife, et al. 2009) reported a linkage between internal control deficiencies to a higher cost of capital. The report concludes a benefit of 100 basis points. An empirical study reported by Lord and Benoit, LLC (Benoit 2006), a SOX research and compliance firm, compared average relative share price movements between companies with material weaknesses in their internal controls over financial reporting as compared to those companies without material weaknesses. The research reported that over a two year period (2005 and 2006) there was a 27.7%

increase in the average share prices for companies that had effective controls in both years, a 25.7% increase in average stock prices for companies that had ineffective 404 controls in year one but effective 404 controls in year two, and a 5.7% decrease in average stock prices of companies that reported ineffective 404 controls for both years.

A study conducted by Glass, Lewis & Co., LLC (Grothe 2007) reported among other findings that the median stock return of companies that disclosed material weaknesses in 2006 underperformed the Russell 3000 index by 18 percentage points. The study also reported that the number of SOX 404 compliant companies that disclosed material weaknesses in 2006 declines 35%; non-SOX 404 companies that disclosed weaknesses rose 20%. Finally, a study by Audit Analytics (2009) reported that restatement rates after a company claimed to have effective internal control over financial reporting was 46% higher for companies that filed management-only reports as compared to those companies that filed auditor attestations.

The opponents argued that the costs to implement Section 404 requirements are high to the point where it is hurting the competitiveness of the U.S. economy and forcing many existing companies to "go dark" and the companies considering IPOs in the U.S. to list their shares on the AIM markets in London. Sadly enough, the high cost arguments were also coming from inside the SEC itself. In a speech delivered to the National Association of State Treasurers, then Commissioner Paul S. Atkins, noted that "perhaps, nothing in recent memory has more starkly illustrated the need to perform honest and probing cost/benefit analyses requirements take effect than the regulatory regime that has grown up under Section 404 of the Sarbanes-Oxley Act" (Atkins, 2005).

Although, the law was passed on July 30, 2002, Section 404 of the Act did not "kick-in" for the accelerated filers until year-endings November 15, 2004 or later. The lack of a PCAOB

generally accepted auditing standard to enable auditors to independently opine on the effectiveness of a client's internal control structure held back the implementation. Even after, the accelerated filers were subjected to this section in 2004; the first year of implanting these requirements was extremely tumultuous for the SEC. It is evident from the fact that within a few months of the issuance of first Section 404 reports the SEC convened a joint Roundtable with the PCAOB and got a earful especially on the issue of that there was no guidance by the Commission for registrant managements to follow in conducting assessment and evaluating the effectiveness of their internal control structure over financial reporting. Recall the same arguments were made in the Senate when it was considering the passage of the Books and records" and "internal control" requirements under the FCPA.

In response, the SEC issued a Staff Statement on Management's Reports on Internal Control on May 16, 2005 in which it noted "the staff will continue to evaluate the implementation of Section 404. The staff desires that the benefits are achieved in a sensible and cost-effective manner. We will continue to consider whether there are other ways we can make the process more efficient and effective while preserving the benefits" (SEC 2005). Subsequently, almost a year later, on June 27, 2007, the SEC issued interpretive Release Nos. 33-8810 and 34-55929 that provided guidance for management in its evaluation and assessment of internal control over financial reporting. One of the co-authors of this paper was serving as an academic fellow with the Commission during this time and was a member of the team working on this project. In spite of all the guidance and evidence of benefits through reduced restatements, lower cost of capital, etc. the opponents continued to argue and finally succeeded in securing exemption from auditor certification

requirements under Section 404(b) for the non-accelerated filers under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[19]

It appears that the opponents of Section 404 based on the cost-issue do not intend to give-up their fight any time soon because on their insistence the Dodd-Frank Act directed the SEC to study how the Commission could reduce the compliance costs of Section 404(b) for companies with market capitalization between $75 million and $250 million while maintaining investor protection and facilitating capital formation in the U.S. through encouraging such companies to list here. In a recent speech dated June 5, 2011, the Commission's Chief Accountant, Jim Kroeker noted that the SEC has completed such a study and makes two specific recommendations for accelerated filers with market capitalization between $75 million and $250 million. The first recommendation is

> that the existing investor protections for accelerated filers to comply with the auditor attestation provisions of Section 404(b) should remain in place. There is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors...the second recommendation was...that the Commission and staff encourage activities that have potential to further improve both effectiveness and efficiency of Section 404(b) implementation (Kroeker 2011).

In December, 2011 H.R. 3606 was introduced in the House by Representative Fincher and S. 1933 was introduced in the Senate by Senator Schumer. These two bills create and define the term "emerging growth company" for purposes of the U.S. Securities laws as a company that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. A company that undertakes an initial public offering remains an emerging growth company until the earlier of when it achieve that revenue level or five years, or is determined to be an "accelerated filer" in accordance with SEC regulations. These two companion pieces of legislation, which were the subject of both House and Senate hearings in December, 2011 would exempt emerging growth

[19] See Section 989G(a) of the Dodd-Frank Act of 2010 that adds Section 404c to the Sarbanes-Oxley Act of 2002.

companies from the Sox 404(b) requirement to have their internal controls audited. It would also reduce the number of years of audited financial statements such companies would have to provide their investors, would exempt such companies from new accounting standards until private companies had to apply them, as well as significantly reduce the disclosures required in annual proxies.

The sponsors of this legislation have introduced it claiming it will increase the number of initial public offerings and facilitate those companies defined as emerging growth companies raising capital. Professor John Coates of Harvard, testifying before the Senate Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs stated:

> Thus, the proposals could not only generate front-page scandals, but reduce the very thing they are being promoted to increase: job growth. Suppose, for example, that the incidence of fraud is likely to be higher among issuers that rely on the reforms. If so, and if investors cannot distinguish between new, higher-fraud-risk issuers from the current flow of lower-fraud-risk issuers, the changes may increase the cost of capital for all issuers at a rate in excess of the increase in new offerings facilitated by lower offering costs. There is rarely a truly free lunch in this world (Coates 2011).

Certainly with bi-partisan support, these latest efforts to roll back audits of internal controls have a reasonable chance of being successful. It is the view of the authors of this paper, that the debate on whether Section 404 reporting is truly enhancing the reliability of the financial statements and disclosures, will subside only with the passage of time, or when those business community opponents achieve their goal of striking SOX 404 from the securities laws.

SECTION IX: CONCLUSION

From the above historical commentary, it is abundantly clear that public reporting on internal control both by an issuer's management and its independent accountants has been the subject of public debate ad nauseam over the years - even decades spanning now over quarter of a

century. Every time these issues were raised in one form or the other, both by the legislative branch and the regulatory agencies, they were dismissed due to pressure from the groups interested in maintaining the status-quo and opaqueness in nation's capital markets. Thus, with the exception of the banking industry, the changes proposed time and time again failed to materialize while the investor losses from poor-quality financial reporting continued to pile-on from financial scandals after scandal. In the end, the Enron and the WorldCom frauds pushed the limits of the Congress and the Republican President who saw no choice but to pass the Sarbanes-Oxley Act of 2002 to reestablish investor confidence and to reassert that quality financial reporting is the bed-rock of our nation's capital markets.

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EXHIBIT 10

Supplemental Materials

Congress works to fix imaginary IPO crisis

By Dan Primack January 5, 2012: 5:00 AM ET

A new bill aims to make it easier for more companies to go public. But what if they don't need to?

FORTUNE -- Congress has proved itself incapable of finding bipartisan solutions to our nation's most acute problems. But when it comes to imaginary crises, it's doing a bang-up job.
Last month Senators Chuck Schumer (D-N.Y.) and Pat Toomey (R-Pa.) introduced new legislation called the Reopening American Capital Markets to Emerging Growth Companies Act. The goal: increase the number of small and midsize companies listed on U.S. public markets through the temporary elimination of regulations like allowing shareholders to vote on **golden-parachute arrangements** for senior company executives.

We've heard this argument before. After the financial crisis, lawmakers were in a panic that U.S. companies would flee to less regulated markets abroad. This time around, the argument goes, more listings will translate into more jobs.

"Reopening" American capital markets to emerging growth companies, of course, presumes that such markets are closed. And were that the case, we should all be pumping pompoms behind Schumer and Toomey. The reality, however, is very different. Through the middle of December, 52 companies backed by venture capital had raised $9.88 billion in 2011 via **initial public offerings** -- names like LinkedIn (**LNKD**), Zynga (**ZNGA**), Fusion-io (**FIO**), and Zipcar (**ZIP**). A larger amount of money has been raised in only five other years since 1980. Does that sound like a job-killing drought? Yes, the actual number of VC-backed IPOs is down from most prior years, but why do Schumer and Toomey expect a plethora of small-cap public companies to foster greater employment than a lesser number of richer companies? Wouldn't it actually be the other way around?
It's not as if the smaller issuers no longer exist. Exactly half of this year's VC-backed IPOs raised less than $100 million, and plenty of those companies are generating under $50 million in annual revenue. For example, look at Pacira Pharmaceuticals (**PCRX**), a New Jersey-based drug company focused on pain management. It was founded in 2007, raised $42 million in a March IPO, and reports just $11.4 million in revenue for the first three quarters of 2011.

And profitability certainly isn't a barrier to going public -- witness Groupon (**GRPN**) and Pandora Media (**P**), which last year raised $700 million and $235 million, respectively, without a dollar in profit.

Why are Congressmen spending valuable time on a quixotic pursuit? Because venture capitalists have asked them to, and VCs are known to be very generous tippers (er, campaign contributors). The 10-year-return benchmark for venture capital is barely above breakeven (1.25%), according to Cambridge Associates. That means many VCs have lost money for their investors and are having

difficulties raising new funds. What these zombies need are more liquidity events, and what better way to get them than by making it easier for their companies to go public? Not through a government-financed bailout, of course, but through a sort of government-aided mulligan of sorts. Never mind that shareholder protections would get watered down; IPOs are apparently a volume business.

Going public is not supposed to be a cakewalk. We've already been through an IPO environment where all you needed was a clever URL and a fuzzy mascot, and the results weren't pretty. I'm not suggesting that last year's issuers are all future members of the **Fortune 500**, but shouldn't a successful listing signal to retail investors that experienced institutions took a hard look at the issuer and considered it worthy of consideration? How can that still be true if those institutions get to see only two years of audited financial statements instead of three? Or if analysts working for a company's underwriting bank can publish pre-IPO research (albeit with a disclaimer)?
Schumer and Toomey's hearts are in the right place, since this legislation is aimed at helping more Americans find work. But their heads are all wrapped up **in a problem that doesn't exist**.

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